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ECONOMIC OVERVIEW

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CONTENTS

WEDNESDAY, FEBRUARY 8, 1984

	Page
Opening statement of Chairman Hatfield	1
Statement of Senator Stennis	2
Prepared statement of Senator Andrews	3
Secretary of the Treasury:	
Statement of Hon. Donald Regan	5
Prepared statement	7
Council of Economic Advisors:	
Statement of Hon. Martin Feldstein	31
Prepared statement	33
Office of Management and Budget:	
Prepared statement of Hon. David A. Stockman	45
Comparison table: Tax Increases Due To Bracket Creep and Scheduled Social Security Tax Increases With Tax Changes Enacted During Reagan Administration	71
Excerpt from Senate Budget Committee testimony	94
Questions submitted to Secretary Regan	122
Questions submitted to Mr. Stockman	129
Questions submitted to Chairman Feldstein	145

WEDNESDAY, FEBRUARY 22, 1984

Congressional Budget Office, statement of Ralph G. Penner	153
Table 1: Budget Outlook Under Current Policies and the Administration's 1985 Budget Proposals	155
Table 2: Administration Deficit Reduction Proposals as Estimated by CBO	157
Table 3: CBO and Administration's Estimates of Administrtion's Budget Program	159
Prepared statement of Rudolph G. Penner	162
Tables 1 and 2: Administration Projection of Real Decline in Cost of Weapons Systems	190, 191
Letter from Alice M. Rivlin, Director, CBO	205
Submitted questions	222

ECONOMIC OVERVIEW FOR FISCAL YEAR 1985

WEDNESDAY, FEBRUARY 8, 1984

U.S. SENATE,
COMMITTEE ON APPROPRIATIONS,
Washington, D.C.

The committee met at 1:30 p.m., in room SD–192, Dirksen Senate Office Building, Hon. Mark O. Hatfield (chairman) presiding.

Present. Senators Hatfield, Stevens, Weicker, Cochran, Andrews, Abdnor, Kasten, D'Amato, Mattingly, Rudman, Specter, Domenici, Stennis, Proxmire, Eagleton, Huddleston, DeConcini and Bumpers.

COMMITTEE ON APPROPRIATIONS

MEMBERS' OPENING STATEMENTS

OPENING STATEMENT OF SENATOR HATFIELD

Chairman HATFIELD. The hearing will please come to order.

Today, we will receive testimony and discuss the President's budget submission for 1985, the fifth such budget in his 3 years in the office, the 1981 reconciliation; the fiscal year 1982; the fiscal year 1983, the fiscal year 1984, and now the fiscal year 1985.

More than ever before, the decisions made by the President and the Congress regarding the future strategy of our economy will have global repercussions. The course we set may steer us toward continued recovery and prosperity, or send us spinning to yet another major recession.

I am encouraged about many things that have occurred in recent months regarding the looming budget crisis.

We have a more realistic perspective on the magnitude of our problems; we have a better handle on the options which are available to us, and we appear to have raised ourselves above the "finger pointing" which highlighted much of last year's budget debate.

There are other matters, however, that concern me a great deal. The first is that this year's budget proposal is sorely lacking the leadership and hardnosed decisions which must be made about our budgetary imbalance. Instead, the administration has proposed to defer consideration on many tax and spending alternatives until later this year or next.

Second, I am concerned about this matter that despite the attempt to recommend a bi-partisan downpayment for Congress, the administration may become totally polarized on even this modest goal.

Finally, I am concerned that the administration and certain members

of Congress remain persistent in their objections to revenue enhancers that might help lead to a meaningful and timely downpayment.

Clearly, substantial spending reductions have already been achieved, and modest entitlement alterations have been set into place. Yet, major tax reductions and proposals such as indexing remain off limits to further negotiations.

Given the magnitude of the problem of a current deficit of almost $84 billion, one which, because of the exponential interests, accumulation will increase as much as $325 billion by 1989. We must consider every and any possibility to bring our budget back into balance and to protect our economy from severe and lasting disruptions.

Senator Stennis, do you have an opening statement?

STATEMENT OF SENATOR STENNIS

Senator STENNIS. I have a brief statement here. This subject matter has been gone over many times. I do want to put this in the record, if I may, and make a simple observation or two.

I think that this matter is just as grave as it could be in this field of fiscal affairs and finance. I think very definitely we can get a remedy, a human remedy, I mean, any that human beings can bring about.

We started out on it, made a little start 3 years ago, but we were bogged down. I think, Mr. Chairman, we have got to go back to the old arithmetic that just says that if you spend more each year than you have or that you take in, you are finally going broke unless you get a remedy and change a pattern, and that sounds mighty simple, but it is a fundamental principle that I agree on, and we live by it.

So I know the practice, at least, and in my small way, I have tried to join into some degree with those that are like-minded and willing to pay the political price, and not count the votes. And I think we have to take it in big doses, larger and larger doses, faster and faster, and already we are already running way behind. We have to begin now, not next year.

Chairman HATFIELD. Senator Stennis, I would imagine that you would agree that in your old-fashioned books, there is only one set of books, too.

Senator STENNIS. Oh, yes. We didn't know anything about all this other.

PREPARED STATEMENT OF SENATOR ANDREWS

Chairman HATFIELD. Any other opening statements? If not, we will reserve a place in the record for opening statements that members wish to submit later.

[The statement follows:]

Prepared Statement of Hon. Mark Andrews, U.S. Senator From North Dakota

It is imperative that we concentrate on the long-term economic outlook as we discuss the current state of the economy. The effect of our policies on both the economic and social systems must be viewed in today's interest rates, mortgage rates, and farm-loan rates, as well as in tomorrow's.

Although we see rosy economic numbers now, the outlook is not likely to continue in the same vein. Unless we make a serious and intense effort to cut the national deficits, we will be forced to deal with increasing interest rates, inflation, or both.

Because of the increased demand by the U.S. Government to finance its $200 billion deficit, interest rates are 2 to 3 percent higher than normal given the other economic factors. Government was able to borrow the $180 billion it needed to finance the deficit in fiscal year 1983 at little real cost to the economy because private business was not yet at the stage of recovery where it needed to borrow to finance expansion. Fiscal year 1984 will be different. We can't afford to let Government borrowing crowd out productive investments.

Not only is the U.S. Government borrowing from this country's investors, we are borrowing from abroad. Last year foreign governments and individuals bought $18.6 billion of U.S. Government securities. That was an increase of 300 percent over 1982. Total foreign holdings outstanding, as of the end of fiscal year 1983, was $162.1 billion.

The major reason we see this type of participation in the U.S. financial markets is because of the high interest rates in the United States. Foreign investors can get a higher rate of return and stability by investing here rather than in their own nations. But these interest rates, as I mentioned before, are artificially high because of the enormous deficit.

What we see happening is an increase of foreign investments to finance our deficit. We are becoming dependent on capital we have no control over, capital that could disinvest (with short-term securities) at any time, causing skyrocketing interest rates as money becomes tighter.

But there is also another consideration. As interest rates are artificially high, so, too, is the U.S. dollar overvalued compared to the value of the Japanese yen and the German mark. The overvalued dollar (by 32 percent according to the Council of Economic Advisors) is fine if you want to take a skiing vacation in Switzerland or lunch on the French Riviera, but for the farmer trying to export his products it is certain death. And the current accounts deficit reflects this. We have the largest trade deficit in recent history—$80 billion for fiscal year 1983. And the export of agricultural products, a key to a healthy farm economy and to a healthy U.S. economy, have suffered because of it.

You can see the bind we have gotten ourselves into. We depend on foreign investment to finance the deficit (helped by the overvalued dollar) but this "help" adversely affects the export of our products (hurt by the overvalued dollar).

The deficit is responsible for keeping the interest rates high, as government competes with private businesses and individuals for money. The high rates attract foreign investors which have, in effect, underwritten the deficit. If they begin to withdraw their investments, interest rates will rise drastically. If we are unable to get the deficit under control, and get Federal borrowing under control, we will be responsible for destroying the country's productive capacity.

I would encourage those testifying today (David Stockman, Donald Regan, and Martin Feldstein) to take the necessary steps on the administration's behalf to make significant cuts in the proposed fiscal year 1985 budget. This budget, as presented by the President, does little to cut the rising $200 billion annual deficits. I would urge you to act and to act swiftly.

SECRETARY OF THE TREASURY

OFFICE OF MANAGEMENT AND BUDGET

COUNCIL OF ECONOMIC ADVISORS

STATEMENTS OF:

HON. DONALD REGAN, SECRETARY OF THE TREASURY

HON. DAVID A. STOCKMAN, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

HON. MARTIN FELDSTEIN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISORS

INTRODUCTION OF WITNESSES

Chairman HATFIELD. We are very pleased and very happy to have a very immediate response to our invitation to the Secretary of the Treasury, Donald Regan; Director of the Office of Management and Budget, David Stockman; and the Chairman of the Economic Advisors to the President, Chairman Feldstein.

Gentlemen, I know you want to get right into the real heart of the hearing process, that is, in the question and answers, and we have a copy of your formal testimony which we made a part of the record.

We would invite you at this time to summarize or to make any opening statement that each of you gentlemen would wish to make, and then we will move from that point directly to the questions.

OPENING STATEMENT OF SECRETARY REGAN

Secretary REGAN. Thank you, Mr. Chairman. I will make a few very brief comments taken from my prepared statement which I have submitted.

The President's fiscal 1985 budget is a realistic document which reduces budget deficits as a percent of Gross National Product from 5.2 percent in fiscal 1984 to 2.3 percent in fiscal 1989. The budget as submitted proposes deficit reduction measures on both the spending and the revenue side of $61 billion over the next 3 years, excluding debt service savings.

DEFICIT REDUCTION DOWNPAYMENT

But the President believes that more can be achieved, which is why he views this budget as a starting point for a good faith, bipartisan negotiation with the Congress on a deficit reduction downpayment of at least $100 billion over the next 3 years.

The adoption of this downpayment, which he believes can be fashioned from less contentious spending cuts and tax loophole measures, many of which he has proposed, would produce significant

progress in deficit reduction, cutting the deficit in fiscal 1989 by more than one half to a level of less than 2 percent of our Gross National Product.

By slowing the growth rate of Federal spending, closing unintended tax loopholes, and examining the recommendations of the Grace Commission, the President believes that substantial tax reductions can be achieved without imposing tax increases on average working Americans and without jeopardizing his defense buildup. He further believes that the adoption of this deficit reduction plan would help insure the economic forecast of many economists for continuing economic recovery, lower inflation, declining unemployment, and falling interest rates.

Mr. Chairman, details on the administration's revenue proposals and some further perspectives on the budget deficit are contained in my stated testimony. I will turn it over now to Dr. Feldstein.

[The prepared statement of Secretary Regan follows:]

PREPARED STATEMENT OF HON. DONALD T. REGAN

SECRETARY OF THE TREASURY

Mr. Chairman and Members of the Committee:

It is a pleasure to be able to report to you that the economy has made a strong recovery and is poised for a long period of expansion without a return to high rates of inflation.

Before discussing the economic outlook and the budget, I want to comment briefly on recent speculation in the press and elsewhere that there are widespread differences of opinion among the President's advisers regarding economic budget policies.

First of all the President sets economic policy. So as has been suggested by the Vice President and others in the White House, let's look at a few recent quotes from the President on matters of the budget and other economic policies.

From the State of the Union Message:

> Now, we know deficits are a cause for worry. But there is a difference of opinion as to whether taxes should be increased, spending cut, or some of both. Fear is expressed that Government borrowing to fund the deficit could inhibit the economic recovery by taking capital needed for business and industrial expansion. I think that debate is missing an important point. Whether Government borrows or increases taxes, it will be taking the same amount of money from the private sector, and, either way, it's too much. Simple fairness dictates Government must not raise taxes on families struggling to pay their bills. The root of the problem is that Government's share is more than we can affort if we are to have a sound economy.
>
> To talk of meeting the present situation by increasing taxes is a Band-Aid solution which does nothing to cure an illness that has been coming on for half a century -- to say nothing of the fact that it poses a real threat to economic recovery. Let's remember that a substantial amount of income tax is presently owed and not paid by people in the underground economy. It would be immoral to tax those who are paying taxes more to compensate for those who aren't paying their share.

From the President's Radio Address of January 21, 1984:

> But let's be clear, the deficits do matter... We must bring deficits down and work toward a balanced budget. The question is: How? By spending cuts and economic growth or by tax increases? I don't think you need to be an economist to understand the evidence. We don't face large deficits because you're not taxed enough. We face those deficits because government spends too much.
>
> Even with our tax reductions now in place, families are still being taxed at near record peace time levels. Yet, as fast as taxes have gone up, spending has gone

up even faster. In the past, raising taxes simply encouraged government to spend more. And since people had less money in their pockets to spend or save, economic growth was hurt. So, fewer people were employed and able to pay taxes. Deficits went up, not down.

Japan, where I recently visited, has had the lowest tax burden and the highest growth rate of all the developed nations...

What we're really talking about is doing things more efficiently without hurting people in need, and without compromising America's security. Yes, we have a deficits problem. When warnings about deficits seem to be hysterical, just remember the lessons of recent history. Predictions are often wrong. Some may be using predictions to mask their favorite pastime: raising your taxes.

From pages 3 and 4 of the Economic Report of the President:

The unwillingness of the Congress to accept the proposals that I offered has made it clear to me that we must wait until after this year's election to enact spending reductions coupled with tax simplification that will eventually eliminate our budget deficit. But we cannot delay until 1985 to start reducing the deficits that are threatening to prevent a sustained and healthy recovery...

The downpayment package can be a first step toward full elimination of the remaining deficits. Even with a 3-year $100 billion package, the deficits projected for fiscal 1986 and beyond are totally unacceptable to me. They would be a serious threat to our Nation's economic health and a heavy burden to future generations. I am committed to finding ways to reduce further the growth of spending and to put the budget on a path that will lead to a balance between outlays and receipts. In 1985 I will submit a budget that can achieve this goal.

If economics has been called the dismal science, I hardly have to tell the members of this committee what putting a budget together is. Reasonable people can and do differ, and a chief executive anywhere -- but especially a President -- is well advised to have a wide variety of opinions set before him before he makes his final decisions. But now, as I have indicated from the quotes, the President has made his budget decisions, and we are here to carry them out.

The President's fiscal 1985 budget is a realistic document which reduces budget deficits as a percent of GNP from 5.2 percent in fiscal 1984 to 2.3 percent in fiscal 1989. The budget, as submitted, proposes deficit reduction measures on both the spending and revenue side, of $61 billion over the next three years, excluding debt service savings.

But the President believes more can be achieved, which is why he views this budget as a starting point for good faith, bipartisan negotiations with Congress on a deficit reduction downpayment of at least $100 billion over the next three years.

The adoption of this downpayment, which he believes can be fashioned from less contentious spending cuts and tax loophole measures, many of which he has proposed, would produce significant

progress in deficit reduction, cutting the deficit in fiscal 1989 by more than one-half, to a level less than 2 percent of GNP.

By slowing the growth rate of federal spending, closing unintended tax loopholes, and examining the recommendations of the Grace Commission, the President believes that substantial deficit reductions can be achieved without imposing tax increases on average working Americans and without jeopardizing his defense build-up.

And he further believes that the adoption of this deficit reduction plan would help assure the economic forecast of many economists for continuing economic recovery, lower inflation, declining unemployment, and falling interest rates.

Economic Overview

It is too easily forgotten just how difficult the economic situation had become by 1980 and how much progress has been made in a few short years.

- During 1980, real GNP actually fell. During 1983 it rose by 6.1 percent. Only two years in the last twenty have posted a larger gain.

- During 1980, employment fell by about 400 thousand persons. During 1983 it rose by 4 million. Nearly 105 million Americans are at work, a record number.

- Real compensation (wages plus fringes) before taxes fell by about 2-1/2 percent in 1980 and by an estimated 3 percent in terms of take-home pay. Real compensation rose by 2 percent in 1983 before taxes and by more than 2-3/4 percent in terms of take-home pay. The real wage gains posted in 1982 and 1983 were the first since a narrow pre-tax increase in 1978.

- During 1980, consumer prices rose by nearly 12-1/2 percent. During last year the rise was 3.8 percent. Chart 1 shows that is the best since 1972. The rise in producer prices was only 0.6 percent in 1983, the best in nearly twenty years.

- In 1980, the prime interest rate hit 21-1/2 percent. Today, the prime rate is 11 percent.

The Administration's economic program is paying dividends now in the form of more jobs and a rising standard of living.

Extending the Recovery

We believe the economic recovery is sustainable. The 6.1 percent real growth rate in 1983 was a good performance for the first year of economic recovery. By the fourth quarter, growth has moderated to an annual rate of 4.5 percent. In conjunction with good inflation performance, this should reduce any concern that the economy is growing too fast.

Currently, the recovery shows no signs of overheating. To keep the recovery proceeding at its recent sustainable, non-inflationary pace, the Administration supports moderate, stable

non-inflationary money growth rates. This is not always easy to achieve, but it is essential.

Essential steps have also been taken in the tax area to ensure a long recovery.

- Marginal income tax rates have been sharply reduced from the levels they would have reached under prior law, although some of the reductions from 1980 levels have already been offset by bracket creep and higher payroll tax rates.

- Starting in 1985, taxpayers no longer will be pushed into higher tax brackets by the combination of inflation and a progressive tax structure. We will not permit "taxflation" to repeal the incentives we have created, or to price American labor and capital out of world markets.

- The rates on capital gains have been reduced again on top of the reductions passed in 1978.

- The tax treatment of depreciation has been restructured to encourage capital spending.

The Economic Outlook

The outlook for 1984 as described in the budget is very encouraging.

- Real GNP is projected to grow 4-1/2 percent between the fourth quarter of 1983 and the fourth quarter of 1984.

- Inflation of 5 percent is expected during 1984, as measured by the GNP deflator. There are no signs of any new outbreak of inflation.

- The rate of unemployment is projected to decline further in 1984, to 7.7 percent by the fourth quarter of the year. It is crucially important to keep the unemployment rate declining.

Financing the Budget Deficit

The Federal deficit was financed in 1983 without extreme pressure on the financial markets. The financing needs of U.S. businesses and consumers have readily been met despite the Federal deficit. State and local surpluses and improvement in the corporate financial picture have been major influences. Higher corporate cash flow enabled corporations to invest without making heavy net demands on credit markets.

Corporate cash flow includes higher allowances for capital consumption under the ACRS provisions of ERTA and larger retained earnings after tax on higher profits. Because of improved business saving, there has been little net borrowing by firms. The volume of business loans at banks is up only about 3 percent, or $6 billion, over the past 14 months since the recession trough in November, 1982. Non-financial corporation commercial paper has fallen by a roughly similar dollar amount.

Even in 1984, the corporate sector will be largely self-financing, requiring only limited bank credit and a small increase in commercial paper or Eurodollar borrowing. Business and personal savings flows will rise with a growing economy. State and local

surpluses and capital inflow will also be available. These sources of funds should cover business, personal and Federal borrowing without a renewed credit crunch.

Difficulties would indeed arise if the Federal deficit were to remain very large at a time when private demands for credit were also high and rising. This is unlikely to be the case in 1984, and may not be in 1985, but the risk is there and should be avoided.

Source of the Deficit

About half of the current Federal budget deficit is due to lingering effects of the recession. That portion of the deficit need not be a cause for lasting concern since it can be removed by the gradual recovery of the economy. Unfortunately, the remaining structural deficit will rise over the next several years unless action is taken to curb it.

The structural deficit is not due to the 1981 tax cuts. Those tax cuts simply hold the ratio of receipts to GNP in an accustomed historical range -- 18% to 20% of GNP. Taxes would have climbed to about 24 percent of GNP by 1988 in the absence of the 1981 tax cuts and tax indexing. Reversal of those tax cuts would only impede the recovery.

This point can be made in very practical terms for individual taxpayers. Chart 2 shows the situation for a family of four with a $25,000 income. If the 1980 tax law had simply been extended forward, their real tax burden (in 1982 dollars) would have increased by nearly 25% by 1988 -- a rise of about $1,000 in 1982 dollars. Under current law, the real tax burden of the family remains approximately constant as a proportion of income at about 1980 levels.

As Table 1 shows, the Economic Recovery Tax Act of 1981, ERTA, was needed largely to offset ongoing tax increases, and its net impact has been reduced further by subsequent legislation. Over the FY 1981 - FY 1989 period, ERTA reduced taxes by fourteen hundred eighty-eight billion dollars. Over the same period, bracket creep from inflation would have raised taxes by $650 billion; the 1977 Social Security Amendments add about $288 billion; TEFRA, about $311 billion; the Surface Transportation Act, $28 billion; the 1983 Social Security Amendments, $90 billion; and $9 billion in other taxes. These total $1375 billion, leaving a net tax cut of $113 billion over 9 years, or only $12.6 billion per year.

We have leveled taxes off as a share of GNP. We have not destroyed the tax base, as some have charged. We have merely said to Washington and the Congress, "Thus far and no farther."

The deficit problem has been created by a failure to control Federal spending. Chart 3 shows the situation. Receipts will average at or above historical levels over the next five years in spite of the Reagan tax cuts.

From 1964 to 1979, receipts averaged 18.8 percent of GNP. In FY 1985-1989, receipts are projected to rise from 19.2 percent to 19.8 percent of GNP. It is outlays that are substantially above historical levels. From 1964 to 1979, outlays, on- and off-budget, averaged 20.5 percent of GNP. In FY 1985-1989, outlays, on- and off-budget are expected to fall from 24.2 percent to 22.2 percent of GNP.

It is government spending which diverts resources to the government from the private sector, whether financed by borrowing

or by taxing. Business and the financial markets and the voters want spending cuts. They don't like deficits; but they don't like taxes either. The choice between taxing and borrowing is a choice between two undesirable alternatives. That choice would not arise if government spending were brought under control.

The Budget Deficit

The projected budget deficit is $180.4 billion in 1985, $177.1 billion in 1986 and $180.5 billion in 1987. It declines to $152.0 billion in 1988 and $123.4 billion in 1989. Chart 4 shows the rise in the on- and off-budget deficit in the recent recessions to a peak of 6.4 percent of GNP in 1983, and the projected decline, to 2.4 percent of GNP in 1989. This is major progress.

Chart 5 shows federal debt held by the public and the Federal Reserve as a percent of GNP. (The chart excludes debt held by Federal trust funds, such as Social Security and the highway trust fund. It includes debt held by U.S. individuals, corporations, pension funds, etc., debt held by the Federal Reserve; and holdings by foreign individuals, business and official institutions such as central banks.) It was nearly 120 percent of GNP at the end of World War II. It was down to 47.6 percent in 1960 and 27.8 percent in 1980 before the last two recessions drove it back up. In 1983 it was 35.4 percent of GNP, about where it was in 1966.

By 1989, taxes will be just under 20 percent of GNP, and total spending just over 22 percent. The on- and off-budget deficit would drop to 2.4 percent of GNP (and lower with a downpayment in 1984 and further spending cuts in 1985). This is low enough to start the debt falling again as a share of GNP by 1988, and enough to start debt service -- interest outlays -- falling as a share of the budget. Then, as interest rates and interest payments fall, and GNP rises, the rest of the budget gap will close. We are not like a third world debtor, with debt service soaring to eat up the whole budget.

The attached Conference Board survey makes these same points.

The main point is this. There is no need to panic. A downpayment on the deficit this year would bring that outyear deficit down below 2 percent of GNP. With state and local surpluses projected at 1 to 1.5 percent of GNP, that would pretty well take total government out of the credit markets.

Thus, with a little more hard work on spending, and a little vote of confidence from the Federal Reserve and the financial markets, we can be out of the woods. And we can do it without wrecking the President's tax incentive program and without choking off economic growth with prohibitive tax rates.

The President is sincerely interested in making a downpayment on the deficit. That is why he called for the bipartisan development of a downpayment deficit reduction plan. He would like this to be comprised of some of the less contentious spending cuts still pending before the Congress, combined with certain measures to close tax loopholes and additional outlay savings based on the Grace Commission. This downpayment could reduce the deficit by at least $100 billion over the next 3 years. Several proposals for deficit reduction are contained in the President's budget. Additional suggestions from the Congress will be welcome.

Assuming that this downpayment is made, and that the Federal budget moves toward balance, and that the Federal Reserve can achieve and maintain a relatively steady and moderate rate of

advance in money, the opportunity will exist for a lengthy sustained economic expansion.

Other major steps toward promoting savings incentives, efficiency and tax fairness can and should be taken. The President has directed me to develop by year end a plan to simplify the entire tax code, so all taxpayers, big and small, are treated more fairly. The objectives of this plan include improved compliance and a broader tax base so that tax rates can be lowered.

The President has also requested better tools to control government spending. He is requesting a Constitutional Amendment to require a balanced budget, and a Constitutional Amendment to provide him with line item veto authority.

Budget Receipts

Total budget receipts in FY 1985 are estimated to be $745.1 billion, an increase of $75.1 billion from the $670.1 billion estimated for 1984. Of this $75 billion, $67.3 billion, almost 90 percent, reflects the effects of economic growth. Budget receipts are projected to increase to $814.9 billion in 1986 and $887.8 billion in 1987. Growth is the key to higher revenues.

Revenue Proposals

The proposals in the Administration's budget will increase receipts by $7.9 billion in 1985, $11.6 billion in 1986, and $14.2 billion in 1987, for a total of approximately $34 billion. These initatives are designed to reduce unintended tax benefits and improve the equity and fairness of the tax system.

The Administration is calling for no new across-the-board tax increases. They would cost jobs and worsen the competitive position of American labor and capital. They are not needed to reach our desired revenue levels. They would only slow the recovery. And finally, it would not be fair to impose higher taxes on those who are paying what they owe, while others do not pay their fair share.

Reintroduced Proposals

Health Care Cap. The Administration proposes to limit the amount of employer-paid health insurance premiums that may be excluded from income and social security taxes. This exclusion creates inequity among employees who receive compensation packages of equal value, but pay quite different amounts of income tax because they receive different amounts of employer-provided health benefits. The exclusion also has encouraged the expansion of elaborate health insurance plans as a substitute for taxable compensation. Over the years this substitution has eroded the income tax base and contributed to the rising cost of medical services. Effective January 1, 1985, health insurance premiums in taxable income to the extent that they exceed $175 per month for family plans and $70 per month for premiums paid under current (but not future) union contracts will continue to be excluded from taxation. This cap would not prevent purchase of adequate coverage; for example, many of the standard plans offered by employers today have total premium costs below the cap.

Our estimates indicate that only 22 percent of employees will be affected by this limitation in 1985. Not surprisingly, affected taxpayers would be concentrated in higher income levels. Whereas fewer than 10 percent of returns with adjusted gross income

below $20,000 would be affected, about 40 percent of returns with AGI above $35,000 would be affected.

Enterprise Zone Legislation. This proposal is similar in all basic elements to the proposal we made last year, except for the effective dates, and very similar to the bill previously reported out of this Committee. It is designed to create a productive free-market environment in economically distressed areas by reducing taxes, government regulations, and other government burdens on economic activity. The program includes Federal tax incentives specially designed to encourage the formation of capital and the creation of jobs, with special emphasis on hiring disadvantaged workers. This is a fresh approach to promoting economic growth in inner cities. Instead of relying heavily on government grants, which often have proven inefficient and ineffective, the enterprise zone approach concentrates on freeing private enterprises to produce, create jobs, and expand.

Tuition Tax Credits. To expand opportunities for families, and to ease the burden of the double payment for those paying public school taxes and private school tuition, the Administration also is reintroducing a proposal to allow taxpayers a credit against their income taxes equal to 50 percent of tuition costs for each child in a private elementary or secondary school. The provisions of this proposal are identical to those contained in a previous Senate Finance Committee bill except that the credit will phase out at income between $40,000 and $60,000 of adjusted gross income, as we originally proposed in 1982, rather than between $40,000 and $50,000, as agreed to by this Committee. The maximum credit per child will be $100 in 1984, $200 in 1985, and $300 in 1986 and thereafter. The Administration supports the strong anti-discrimination provisions adopted by the Senate Finance Committee last year.

Education Savings Accounts. To help low- and middle-income families pay future higher education expenses of their children, taxpayers will be permitted a tax exclusion for the earnings on savings deposited in special education savings accounts. The maximum annual contribution to these accounts will be limited to $1,000 per child. This ceiling will be reduced five cents for each dollar that the taxpayer's adjusted gross income in the prior year exceeds $40,000. Thus, no deposits could be made by families with more than $60,000 of income.

Expenses may be paid out of savings held in these accounts for tuition and room and board of full-time dependent children enrolled in undergraduate degree programs in schools that do not follow a policy of racial discrimination. These expenses must be paid directly to the university or college. Savings withdrawn for any other purpose will be assessed a penalty, except for amounts withdrawn as a result of a child's death or unusual medical expenses incurred by the child.

In order to encourage families to begin saving early for a child's higher education, deposits may be placed in these special savings accounts on behalf of any dependent children under the age of 18. In no case may an account be kept open for a child over the age of 26.

New Initiatives

Family Initiatives. The President has endorsed a package of tax proposals intended to promote the fair treatment of families under the tax system. In recognition of the important economic

contributions made by spouses who do not work outside the home, the combined limit for contributions to individual retirement accounts (IRA's) for a husband and wife in such instances will be increased from $2,250 to $4,000. Every married couple that files a joint return thus will be able to deduct annual IRA contributions up to the lesser of $4,000 or 100 percent of the annual compensation received by the couple. In addition, alimony will be treated as compensation in determining the IRA deduction limit applicable to divorced individuals.

Dependent care organizations play an important role in enabling individuals, especially women, to continue their careers. We are proposing that tax-exempt status be provided to any nonprofit, dependent care facility if it is operated to provide nonresidential care, substantially all of the dependent care is provided to enable individuals to be gainfully employed, and the services provided are available to the general public. The dependent care credit available to low- and middle-income taxpayers also will be increased, with the credit available to high-income taxpayers reduced. Those taxpayers with adjusted gross incomes of $60,000 or more would receive no credit.

Research and Experimentation. Industry should be encouraged to undertake research and experimentation that may lead to productivity-enhancing innovation. To enable taxpayers to plan their R&E activities with certainty that the credit will be available, the Administration proposes to extend the R&E credit through 1988. The definition of R&E will be modified to target the credit more effectively.

To maintain current incentives for R&E conducted in the United States pending further consideration, we propose to extend for two years the moratorium on the application of Treasury regulations relating to allocations of R&E to foreign source income.

Response to International Concerns. First in this category of proposals is the introduction of a withholding system with respect to taxes on gains of foreign persons on the sale of U.S. real property. This proposed withholding system will significantly increase compliance with U.S. tax law by foreign sellers of U.S. real property interests.

In order to alleviate concerns expressed by members of the General Agreement on Tariffs and Trade (GATT) concerning the present tax deferral available to domestic international sales corporations, we propose to replace that system with a new system for taxing export sales income. This new system is intended to preserve the competitiveness of U.S. exports while addressing concerns expressed by other GATT members. We appreciate the cooperation of this Committee in scheduling hearings on this important legislation for tomorrow.

Finally, in recognition of the sacrifice that members of the U.S. Armed Forces and employees of the U.S. government must be prepared to make when they leave our borders, we propose to grant a tax exemption for U.S. military or civilian personnel who die as a result of injuries sustained outside the United States in a terrorist or military action. It is tragic to think of widows of marines killed in Lebanon paying income taxes on their husbands' past wages.

TIM's. The Administration also proposes changes in the tax law necessary to accommodate Trusts for Investment in Mortgages (TIM's). These changes are expected to expand the private secondary mortgage market, attracting additional capital to support long-term mortgage lending activity.

Structural Tax Reform Proposals. The Administration is introducing proposals to reform three areas of the tax law. The first will impose limitations on the availability of ACRS and investment tax credits on certain property leased by Federal, state, or local governments or organizations not subject to U.S. tax. This proposal will prevent the tax shelter-type transactions that have received widespread publicity, such as recent transactions entered into by certain municipalities and colleges. The Committee previously has approved this provision in last year's reconciliation bill, and we are happy to restate our support.

The second of the structural reform proposals involves broad-based improvements in the taxation of life insurance companies and their products. Under this proposal a carefully worked out single-phase system will replace the 25-year old two-phase system of taxing life insurance companies. In addition, "life insurance" will be defined to remove ambiguity concerning certain innovative products that have been introduced by the insurance industry.

Third, the Administration supports proposals that will impose a number of restrictions to limit the alarming growth of private purpose tax-exempt bonds. The total volume of these bonds has grown 570 percent from 1975 through 1982. The revenue loss to the Federal government from these bonds is substantial. For example, we estimate the revenue loss from all outstanding private purpose tax exempt bonds issued in FY 1984 to be over $8 billion dollars. The limitations we propose are similar to the limitations contained in H.R. 4170, as we expect it to be amended by the Ways and Means Committee. The proposals include state-by-state annual volume limitations on industrial development bonds and student loan bonds. The proposal also denies tax-exempt status for bonds guaranteed or backed by certain Federal agencies and subjects obligations issued by Puerto Rico and U.S. Possessions to the rules presently applied to those of State and local governments.

Curtailment of Tax Shelter, Accounting, and Corporate Tax Abuses. We have identified many transactions that are designed to create unintended tax benefits. These transactions frequently are the cornerstone of tax shelter schemes and in most cases involve what we consider misuse of the partnership, accounting, and corporate tax provisions of the Code. We are proposing a number of technical amendments to curtail these transactions.

The proposals will restrict the ability that partners may have under current law to allocate partnership income in abusive transactions. In addition, existing rules that were designed to restrict tax-motivated retroactive partnership allocations will be tightened.

Current tax accounting provisions provide taxpayers with significant flexibility in determining the time at which they must report income and deduction items and the amount of interest that must be charged on loans and deferred payment sales of property. Because the tax code does not adequately address the time value of money, we have seen an alarming number of transactions that abuse this flexibility. These transactions permit taxpayers to accelerate or inflate income tax deductions (for example, by taking a current deduction for the estimated cost of expenses to be paid for in the future) and to claim inflated ACRS allowances and investment tax credits. The proposals will tighten certain of the tax accounting provisions of the Code in order to stop taxpayers from claiming unintended tax benefits.

Several proposals are designed to preclude sophisticated corporate taxpayers from abusing the rules relating to the taxation

of corporate dividends, short sales, real estate investment trusts, and regulated investment companies. The rules governing the taxation of transfers of property to foreign corporations will be tightened. We also need to end abuses involving charitable contributions, tax-free exchanges of property, securities straddles, and collapsible corporations.

Miscellaneous Provisions. Finally, the Administration proposes to extend the targeted jobs tax credit and to extend the PIK program to farmers who participate in the 1984 winter wheat program.

Employee contributions to civil service retirement will be increased from 7 percent of wages and salaries to 8 percent effective October, 1984, and to 9 percent effective October, 1985. For District of Columbia employees, the D.C. Government contribution will increase correspondingly. In addition, regular Federal/State unemployment insurance coverage will be extended to railroad employment, effective January 1, 1985.

It should be noted also that the budget adopts the assumption that certain trust fund taxes will be extended even though, under current law, they are scheduled to expire. These trust fund taxes are the Superfund taxes on hazardous substances, which expire at the end of fiscal year 1985, the Airport and Airways Trust Fund taxes, which expire at the end of calendar year 1987 and the Highway Trust Fund taxes, which expire at the end of fiscal year 1988. Our estimate of budget receipts, therefore, includes the extension of these trust fund taxes as well as the tax proposals I have previously enumerated.

Improved Tax Compliance

Failure to comply fully with our tax law benefits a few at the expense of the vast majority of honest taxpayers. We must redouble our efforts to narrow the tax gap between the correct tax liability owed and the amount taxpayers voluntarily pay. As the President indicated in his State of the Union Address, it would be immoral to make those who are paying taxes pay more to compensate for those who aren't paying their share.

We expect that a number of the proposals I have just outlined to curtail tax shelter, accounting, and corporate tax abuses also will improve tax compliance. And the IRS budget we are seeking for FY 1985 includes some 1,900 new positions--$64 million in additional outlays targeted to improve document matching, increase examination efforts, particularly for unincorporated nonfarm businesses, and implement the backup withholding system in the 1983 Interest and Dividend Tax Compliance Act.

We have seen enacted since this Administration took office a number of tough measures to improve compliance. For example, while it is too early to provide specific data on the effect of the recently broadened system of backup withholding, preliminary information indicates that 7 to 10 percent of reported taxpayer identification numbers are in error. Consequently, efforts by payers to obtain accurate numbers in response to the new backup withholding provisions will facilitate improved matching by the Internal Revenue Service of information documents on dividends and interest to tax returns and thereby help narrow the tax gap. Another example is the new tip reporting system enacted in 1982. Following this change, IRS data from Form 941 tax returns show that the amount of taxable tips in the first three quarters of 1983 were more than double the amount in the first three quarters of 1982.

Fundamental Tax Reform

While the new tax initiatives we are introducing are of immediate importance because they improve the equity and fairness of the present system, I would like to turn now to the much broader issue of fundamental tax reform.

Last week, in his State of the Union Message, the President directed me to develop a plan of action to simplify the entire tax code so all taxpayers, big and small, are treated more fairly. The objectives of this plan include improved compliance and a broader tax base so that tax rates can be lowered. I will present a set of specific recommendations, consistent with these objectives, to the President by December 1984.

The President recognizes that the time to act is now. We no longer control the tax system. It controls us.

Since 1980 we have made great strides. We, and by we I mean this Administration, this Committee, and the entire Congress, have moved in the proper direction. We have recognized some of the major problems of the income tax structure we inherited and we have done something about them.

- o High individual income tax rates were sapping incentives to work, save, and invest. We cut them 23 percent across the board.

- o Bracket creep was taking increasing amounts of after-tax real dollars from the pockets of individual taxpayers with a given real income, even in years when there were no explicit tax increases. We indexed the individual tax structure to eliminate permanently these unlegislated tax increases and to prevent government from raising more revenue simply through inflation.

- o An antiquated and complex system of tax depreciation that was inadequate during periods of high inflation was helping to depress the rate of business expansion and modernization. We have replaced this system with a simplified accelerated cost recovery system that assures business the funds needed for capital improvement.

While these changes have halted the continuing rise in marginal tax rates and restored needed overall incentives for capital formation, major structural problems in the current income tax still remain. Therefore, this Administration is committed to consider a major overhaul of our tax structure.

Households and businesses must be allowed to make the best use of the resources at their disposal with a minimum of intrusion by tax considerations. Efficient use of resources requires a tax system that does not interfere with economic decisions in a capricious and haphazard manner. Under our present income tax structure, the size of your tax bill depends not only upon the size of your income but also upon how you earn your income and how you spend your income.

This complexity leads many households and businesses to consult tax planners before making any major decision affecting their pocketbooks. Every decision made on the basis of tax considerations rather than economic considerations is robbing us all each day.

Only with a tax system that does not discriminate among ways

of earning and spending money can we achieve the highest attainable level of economic growth. We must recognize that any deviations from this standard will cause the Nation's resources to be allocated in a less than optimal fashion, resulting in lower productivity, a dampened rate of economic expansion, and in the end, a lower standard of living for all.

We already have spent a good deal of time at the Treasury Department during 1982 and 1983 examining ways to make fundamental changes in our current tax structure. We are considering a number of approaches including a consumed income tax -- a broad-base tax on all sources of income with a deduction for net savings, a value-added tax, and various forms of broad-based, low-rate income taxes. At the President's direction, we will intensify our study of these and other tax alternatives over the next 11 months.

By December 1984, I expect to have for the President a set of specific recommendations for fundamental changes in our present income tax structure that will make our system of taxation much simpler, more fair, more neutral, and more efficient while fostering economic growth. If we can develop a system of taxation based on these goals, we will encourage better compliance and reduce the reward for engaging in either tax shelters or the underground economy.

For us at Treasury this will be a year of intensive study. In the course of this study we will have to deal with some very difficult issues associated with any radical transformation of the income tax structure. Some tough and unpopular decisions will be part of the price to pay for a simple, neutral, and equitable system of taxation.

I know that you, Mr. Chairman, and members of this committee recognize that this is a tall order to fill. The present Internal Revenue Code was written over a number of decades. As a result, the tax law has accumulated many patchwork provisions, often designed to meet temporary needs of particular interest groups, that have added to the complexity of the system and distorted economic choices. It is time to take a fresh look at our entire tax system.

Chart 1

CONSUMER PRICE INDEX

(Monthly Data, Percent Change from Year Earlier)

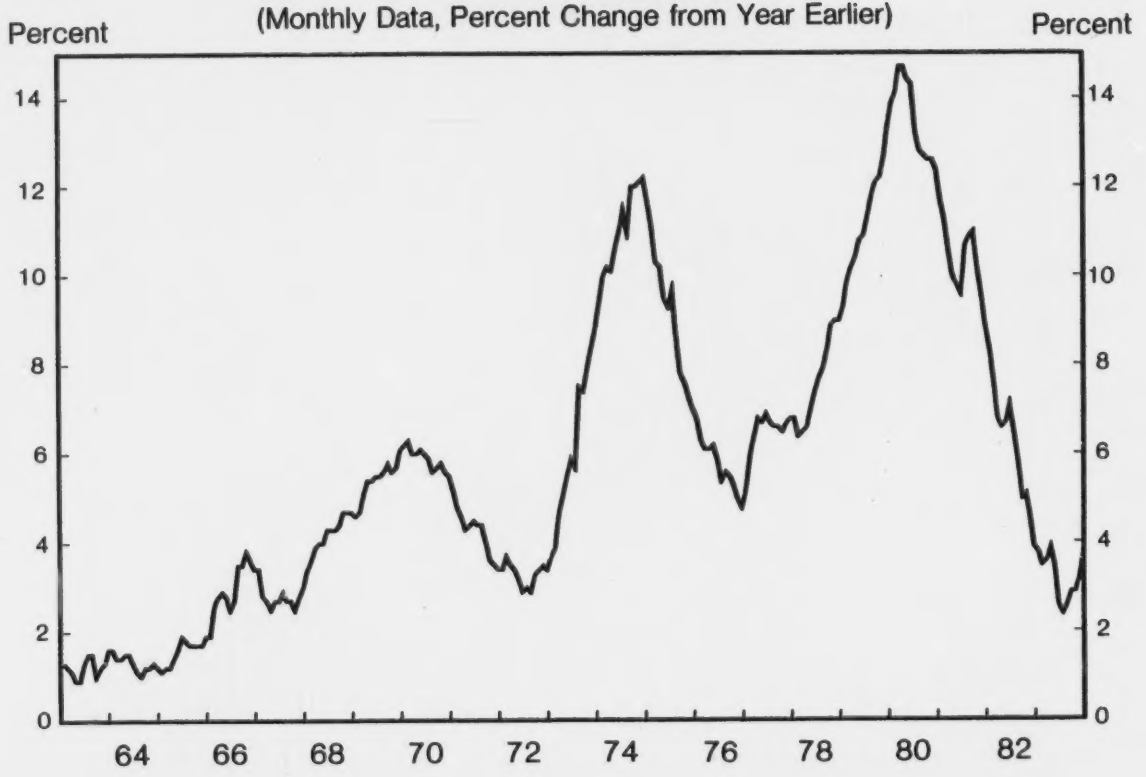


Chart 1a

PRODUCER PRICE INDEX

(Monthly Data, Percent Change from Year Earlier)

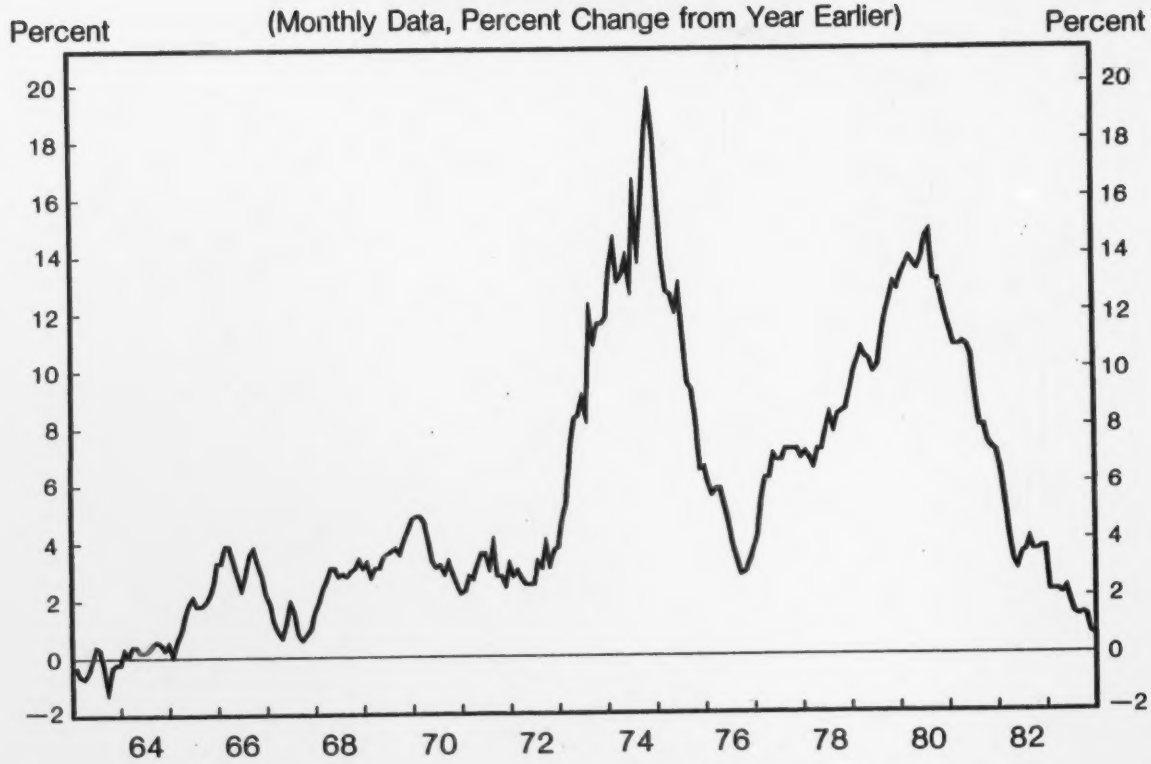


Chart 2

REAL TAX BURDEN
(INCOME & EMPLOYEE PAYROLL TAX)

Family of Four with an Income of $25,000 in 1982 with Cost of Living Adjustments

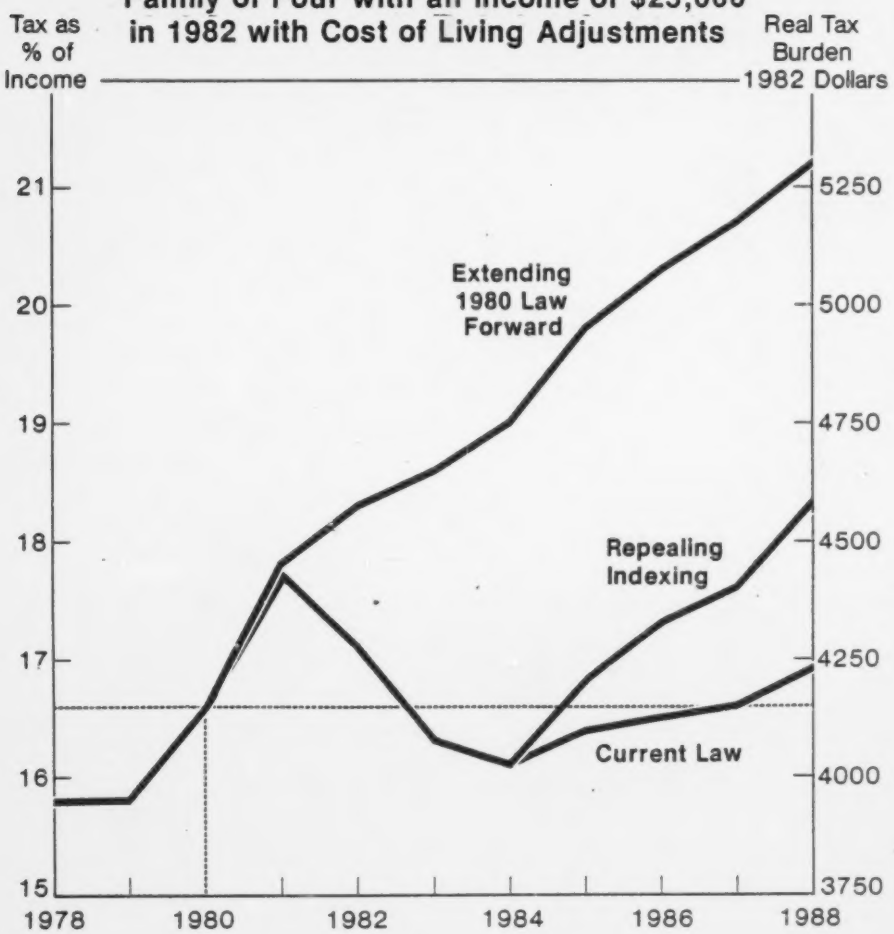


Table 1

WHAT IS LEFT OF THE TAX CUT?

FY 1981 — FY 1989

($ billions)

			Fiscal Years 1981 through 1989
Tax Cut:	Economic Recovery Tax Act of 1981 (ERTA)		—$1,488.4 billion
Tax Increases:	Inflation-Induced Bracket Creep	+$649.8	
	1977 Social Security Tax Rate Increases	+$287.5	
	Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)	+$310.6	
	Gasoline Tax Increase	+$ 28.0	
	1983 Social Security Amendments	+$ 90.2	
	Other	+$ 9.1	
Total Tax Increases			+$1,375.2 billion
Net Tax Cut			—$ 113.2 billion
Nine Year Average Net Tax Cut			—$ 12.6 billion

Table 1a

A Comparison of the Tax Increases due to Bracket Creep and the Scheduled Social Security Tax Increases with the Tax Changes Enacted During te Reagan Administration

($ billions)

	Fiscal Years									
	1981	1982	1983	1984	1985	1986	1987	1988	1989	Total 1981-1989
Tax increases since 1980 resulting from:										
Bracket creep due to inflation 1/	5.6	25.1	38.5	47.4	60.4	79.0	102.5	130.4	160.9	649.8
Scheduled social security increases 2/	9.8	17.0	19.3	20.9	31.2	39.1	45.8	50.2	54.2	287.5
Total, increases	15.4	42.1	57.8	68.3	91.6	118.1	148.3	180.6	215.1	937.3
Tax changes enacted during the Reagan Administration:										
ERTA (1981)	-0.3	-40.2	-91.1	-133.6	-165.0	-207.7	-248.5	-282.7	-319.2	-1488.4
TEFRA (1982) 3/	--	*	16.5	32.8	37.3	46.8	58.0	59.6	59.6	310.6
Surface Transportation Act (1982) 4/	--	--	1.5	4.1	4.2	4.4	4.5	4.6	4.7	28.0
Social security amendments (1983)	--	--	--	6.2	8.8	9.3	11.4	23.4	31.1	90.2
Other 3/5/	--	--	--	0.2	0.8	1.5	2.1	2.2	2.3	9.1
Total, enacted changes	-0.3	-40.2	-73.0	-90.3	-113.8	-145.7	-172.6	-192.9	-221.6	-1050.5
Net tax change from 1980 Law	15.0	1.9	-15.2	-22.0	-22.2	-27.7	-24.3	-12.3	-6.4	-113.2

Office of the Secretary of the Treasury
Office of Tax Analysis

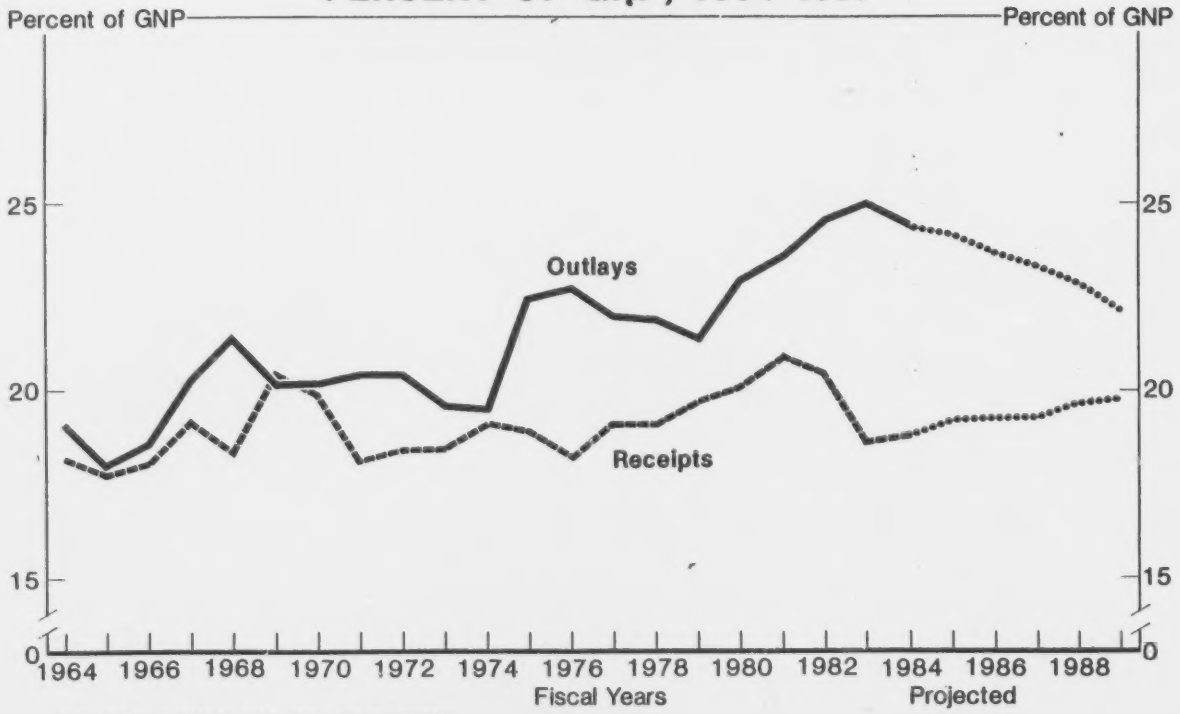
February 1, 1984

Note: Details may not add to totals due to rounding.
*Less than $50 million.

1/ Amounts shown are the increases in individual income tax receipts (that would have been realized prior to the changes enacted during the Reagan Administration) resulting from inflation induced increases in effective tax rates since 1980.
2/ Effective rate increases from the structure in effect in 1980 (includes changes in the statutory rates in 1981-1989 and the ad hoc increase in the wage base for 1981 enacted in the 1977 social security amendments).
3/ Withholding on interest and dividends is excluded from the revenue effects of TEFRA; revenue effects of backup withholding ($1.1 billion in 1988) are included in "other".
4/ Amounts shown are the effect of the Surface Transportation Act on current services receipts, i.e., the effect of the Act extended beyond the expiration date compared to prior law extended beyond the expiration date.
5/ Railroad Retirement Revenue Act of 1983 and backup withholding only.

Chart 3

OUTLAYS AND RECEIPTS AS PERCENT OF GNP, 1964-1989



Note: Outlays include off-budget federal entities.

Table 2

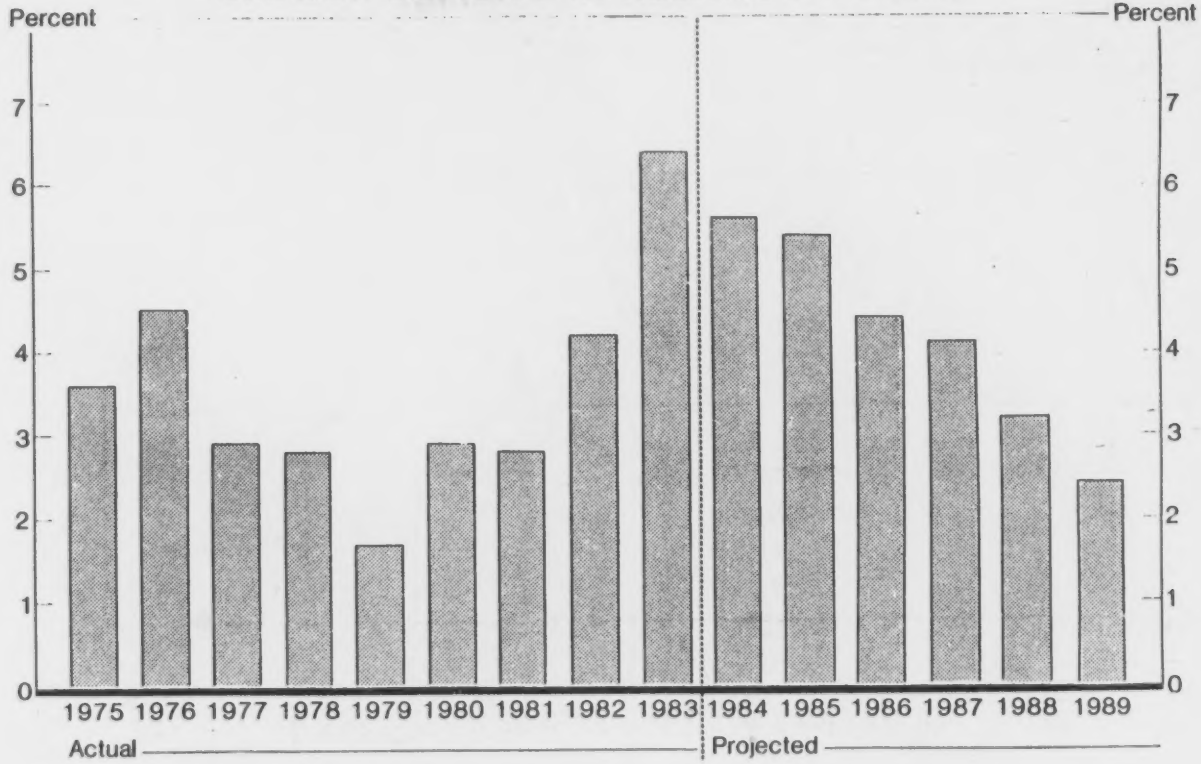
OUTLAYS AND RECEIPTS AS PERCENT OF GNP

	Receipts	Outlays*
1985-1989	19.5	23.3
1984	18.8	24.4
1983	18.6	25.0
1982	20.2	24.4
1981	20.8	23.5
1980	20.1	22.9
1964-1979 (avg.)	18.8	20.5

* Including off-budget spending.

Chart 4

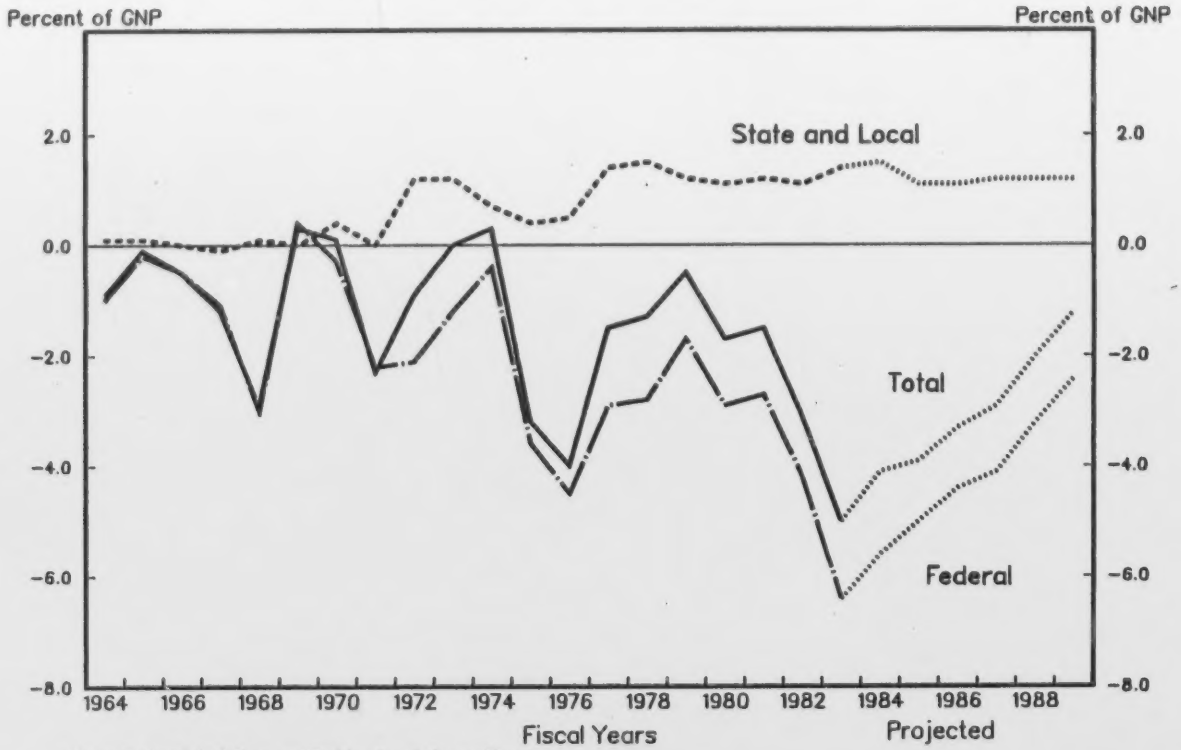
BUDGET DEFICITS IN RELATION TO GNP*



*On and off budget as percent of fiscal year GNP.

Chart 4a

Total Government Surplus or Deficit



Note: Federal deficit on unified basis, state and local on National Income Basis.

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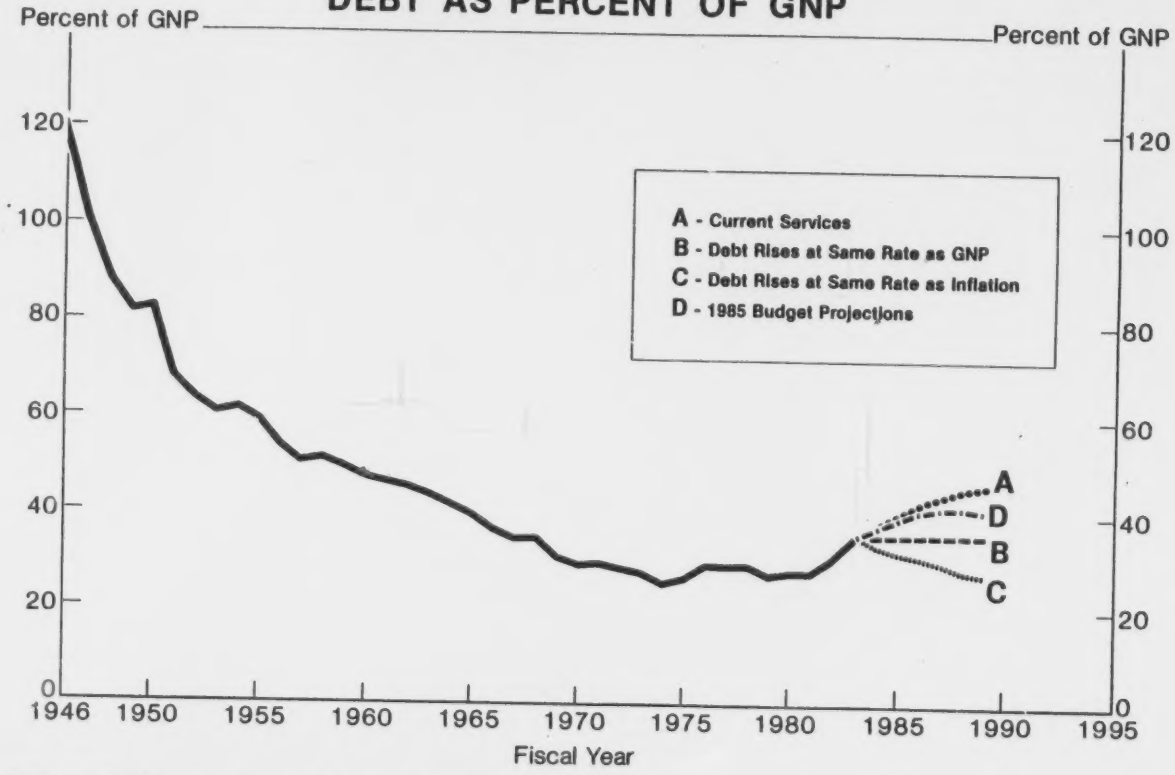
Chart 5

DEBT AS PERCENT OF GNP



Note: Debt held by the public, including the Federal Reserve.

Table 3

FEDERAL DEFICITS UNDER VARIOUS DEBT TARGETS

(billions of dollars)

Fiscal Year	A Current Services	B Debt a Constant Share of GNP, Rising at Same Rate as GNP	C Debt of Constant Real Value, Rising with Inflation (GNP Deflator)	D 1985 Budget Projections
1984	$203.6	$116.7	$49.0	$199.9
1985	225.6	117.2	58.2	195.2
1986	232.6	120.6	57.2	185.9
1987	236.6	126.6	56.0	187.7
1988	220.6	132.2	54.3	159.7
1989	207.8	136.4	52.2	128.2

Note: Deficits include off budget items. Debt held by the public, including the Federal Reserve.

OPENING STATEMENT OF MR. FELDSTEIN

Mr. FELDSTEIN. The prepared statement that I have submitted talks about the economic outlook, and I think it might be useful if I summarized it. The outlook that we use for making these budget calculations is certainly a very favorable one. We indicate that we anticipate inflation of 5 percent this year and then declining gradually to 3½ percent by 1989.

INTEREST RATES

Of particular importance is the interest rate. The combination of lower inflation and declining budget deficits could bring the interest rate down from the 9 percent level of Treasury bills today to 5 percent by 1989. That is built into the forecast.

GNP GROWTH RATE

Finally, we have a good solid rate of growth of real GNP, 4½ percent in the current year, and then 4 percent a year in each of the next years through 1988, followed by slightly less than that in 1989. We don't try to make year by year forecasts in any of these variables, but rather to indicate the trends and where the levels could be at the end of our forecast period.

DOWNPAYMENT ON DEFICITS

Certainly, it is a very favorable outlook for inflation, for real growth, for interest rates, and yet it is clear that even with this favorable prognosis, growth and falling interest rates are not enough by themselves to bring the deficits down to a manageable level. That is why we are talking today about the need for a downpayment as a result of these bipartisan negotiations and why it has to be seen just as a downpayment—why further fiscal action would be necessary in 1985.

I should stress that these forecasts, this outlook is not like a conventional business forecast, but, rather, it is conditional upon the policy assumptions that we make with respect to both fiscal and monetary policy. Typically, a business forecaster tries to make a guess at what is going to happen to policy, about the monetary and fiscal side and bases his forecast on his best guess of what policy will be. What we are doing quite explicitly is saying that this forecast is based upon the kind of policies we want, upon the kind of monetary policy and upon the kind of deficit reduction policy.

Without that, without sharply falling deficits and a sound monetary policy, it would clearly be wrong to assume that interest rates will come down from their current high levels. It would be wrong to assume that the recovery will be a balanced and healthy one, and I think it would probably be wrong to assume that inflation will fall.

FORECASTS ON INFLATION RATES

With the assumption of sharply falling deficits, with the assumption that these negotiations are succesful in producing $100 billion or so over the next fiscal years, and that there will be a more substantial fol-

lowup in calendar year 1985, I think that our forecasts, and our economic assumptions are not at all unreasonable. An inflation rate of 3½ percent for 1989 certainly is a major improvement over the inflation experience of the late 1970's, and yet it really represents bringing inflation back into line with the kind of experience the United States enjoyed in the 1950's to 1960's. The inflation rate in those decades was only 2½ percent. So our assumption of 3½ percent by the end of the decade, conditional on good monetary and fiscal policy, is not at all unreasonable.

Similarly, between 1950 and 1967 the Treasury bill rate never rose above 5 percent. Therefore, the assumption that we could bring it down to 5 percent by 1989, if there is appropriate monetary and fiscal policy, I think is quite reasonable.

GNP REAL GROWTH

In the first 7 years of recovery, in the first 7 years after the business cycle upturn during the post-war period, the average rate of real growth of GNP was 4 percent. By comparison, we assume 4.3 percent. It is a little bit more, but not at all unrealistically high if we have the right kind of monetary and fiscal policy. We all recognize that we need to reduce deficits. We all recognize that 1984 is not a year in which Congress is going to enact everything that is needed to get the budget down to a balance. But we do think that a major downpayment this year followed by further action in 1985 will give us the fiscal room and make it possible to pursue the monetary policy which will allow the economy to have the kind of favorable economic performance that we talk about here.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Feldstein follows:]

Prepared Statement of Martin Feldstein

chairman

Council of Economic Advisers

The Economic Outlook

Thank you, Mr. Chairman. I am very pleased to be with this distinguished Committee today to discuss the economic outlook and the economic assumptions used in the Administration's budget calculations.

The Outlook for 1984-89

The Administration's new economic projections for 1984 through 1989 are shown in Tables 1 and 2. Our current economic assumptions repeat last year's projections that the economy will experience strong growth with declining inflation over the next six years.

Real GNP is projected to grow 4.5 percent between the fourth quarter of 1983 and the fourth quarter of 1984. The inflation rate, as measured by the GNP deflator, is projected to be 5.0 percent over the same period. This coincides with the Administration's projections in the midsession review prepared in June of last year, and with last February's inflation projection. It represents an increase of one-half percent from the growth rate projected in the outlook that I presented here last February.

Table 1

Six Year Economic Assumptions: Growth Rates

	Real GNP Growth Rate	
	4th Quarter to 4th Quarter	Year to Year
1984	4.5	5.3
1985	4.0	4.1
1986	4.0	4.0
1987	4.0	4.0
1988	4.0	4.0
1989	3.7	3.9

	Inflation GNP Deflator	
	4th Quarter to 4th Quarter	Year to Year
1984	5.0	4.5
1985	4.7	4.8
1986	4.4	4.5
1987	4.1	4.2
1988	3.8	3.9
1989	3.5	3.6

	Nominal GNP Growth Rate	
	4th Quarter to 4th Quarter	Year to Year
1984	9.7	10.0
1985	8.9	9.1
1986	8.6	8.7
1987	8.3	8.4
1988	8.0	8.1
1989	7.4	7.6

Table 2

Six Year Economic Assumptions: Levels

	Real GNP Growth Rate (1972 dollars)		
	Calendar Year	Fourth Quarter	Fiscal Year
1984	1616.0	1641.3	1598.3
1985	1682.2	1707.0	1665.7
1986	1749.5	1775.3	1732.4
1987	1819.5	1846.3	1801.7
1988	1892.3	1920.2	1873.8
1989	1965.7	1992.3	1947.7

	GNP Deflator (1972 = 100)		
	Calendar Year	Fourth Quarter	Fiscal Year
1984	225.4	229.5	222.7
1985	236.2	240.3	233.5
1986	246.9	250.9	244.2
1987	257.3	261.1	254.7
1988	267.4	271.1	264.9
1989	277.0	280.6	274.6

	Nominal GNP Growth Rate		
	Calendar Year	Fourth Quarter	Fiscal Year
1984	3642.4	3766.8	3558.9
1985	3973.8	4101.6	3890.1
1986	4319.2	4453.5	4231.3
1987	4681.2	4821.4	4589.3
1988	5059.0	5205.1	4963.0
1989	5444.9	5589.4	5348.8

	Total Unemployment Rate		91-Day Treasury Bill	
	Annual Average	Final Quarter	Annual Average	Final Quarter
1984	7.8	7.7	8.5	8.3
1985	7.6	7.5	7.7	7.5
1986	7.3	7.2	7.1	6.9
1987	6.8	6.5	6.2	6.0
1988	6.1	5.8	5.5	5.3
1989	5.7	5.7	5.0	5.0

For 1985 through 1988, real GNP is projected to grow at 4.0 percent annually, the same growth rate that we projected for these four years in our outlook of a year ago. We assume that capacity is approached at the end of this period and that real GNP in 1989 is then projected to grow at 3.75 percent.

These growth rates are associated with a substantially improved outlook for unemployment in recent months, the average unemployment rate for 1984 is now projected to be 7.8 percent. The current projection of the unemployment rate indicates that unemployment will decline gradually to a rate of 5.7 percent in 1989. This reflects the completion of the cyclical recovery and the effects of the Administration's enacted and proposed employment policies in reducing the structural unemployment rate.

Another unexpectedly favorable development in recent months has been the rapid decline in inflation. Inflation, as measured by the GNP deflator, has been less in 1983 than the 4.6 percent anticipated in the midsession review. Although we continue to project a 5.0 percent rise in the 1984 GNP deflator, the inflation rate is then projected to decline gradually but steadily to 3.5 percent by 1989.

The combination of falling inflation and declining budget deficits imply that nominal and real interest rates will also decline. Our projections assume that the interest rate on three-month Treasury bills declines from the current level of nearly 9.0 percent to 5.0 percent in 1989.

The Administration's projections for 1984 are very similar to the thinking of most private economists. The consensus of the 45 economists in the January 1984 survey indicated a real GNP growth rate of 4.4 percent from the fourth quarter of 1983 to the fourth quarter of 1984, almost identical to the

Administration's projected 4.5 percent rate. Similarly, the Blue Chip consensus indicates a GNP deflator increase of 5.2 percent in 1984, also almost identical to the Administration's 5.0 percent rate of inflation.

Our projections for 1984 are consistent with the recent pace of economic activity, with the sizeable fiscal stimulus of an approximately $140 billion structural deficit, and with the expectation that the money supply will continue to grow enough to support nominal GNP growth of nearly 10 percent.

The Administration's economic assumptions for 1985 and beyond must be interpreted wih care because they are conceptually different from the type of forecast that private economists make and, presumably, from the forecasts of the Congressional Budget Office. There are two quite important differences.

Conditional Forecasts

First, our economic assumptions for 1985 through 1989 are based on the premise that legislative action will reduce budget deficits sharply in the years ahead. More specifically, in the current situation, this means that the bipartisan negotiations will be fruitful and will reduce the deficit by about $100 billion or more over the next few years. Of course, even if the negotiations are fully successful, the future budget deficits would remain too large. The Congress must therefore also enact legislation that will be proposed in 1985 to slash deficits sharply before the end of the decade, moving the budget closer to balance. If such deficit reductions are not enacted, the interest rates are not likely to fall over the next five years as we have projected and growth of real GNP is likely to be slower than we have assumed.

Moreover, larger deficits might induce a monetary policy that raises the rate of inflation in the years ahead.

If there is legislative action to reduce future budget deficits sharply as we have assumed, the Administration's projected performance of the economy provides a plausible picture of our economic future. The Administration's projections imply that the average annual rate of growth of real GNP in the seven years from the business cycle trough in the final quarter of 1982 to the final quarter of 1989 will be 4.3 percent. By comparison, the first seven years after the previous business cycle troughs in all of the pastwar recessions (except the 1980 trough since we do not yet have seven years of experience) had average annual growth rates of 4.0 percent. The difference of 0.3 percent a year between our projections and previous experience is not large and it is certainly not unreasonable as a response to the improved monetary and fiscal policies that we assume for the remainder of the decade.

Most private forecasters currently project that deficits will be reduced after 1984 but not by as much as the Administration assumes. Many of these forecasters also believe that monetary policy will not be as conducive to noninflationary growth as we have assumed. Their forecasts point to lower growth of real GNP and higher inflation than the Administration's projections. More specifically, in the Blue Chip Survey of leading private forecasters, the projected level of real GNP in 1989 is 3.7 percent lower than the level projected by the Administration. This represents a difference of 0.6 percent as the average annual rate of growth between 1983 and 1989. With the same rate of inflation, the slower growth implies that the level of GNP in 1989 would be $203

billion less than the $5,445 billion projected by the Administration for that year.

The 5.0 percent rise in the GNP deflator that the Administration projects for 1984 is very close to the average of 5.2 percent projected by the private forecasters in the most recent (January 1984) Blue Chip Survey. After 1984, the Administration forecasts that the inflation rate will fall by 0.3 percent a year to 3.5 percent in 1989. Since the private forecasters do not currently anticipate sharply falling deficits and an anti-inflationary monetary policy, they project that the rate of increase of the GNP deflator will remain between 5 percent and 6 percent for the remainder of the decade.

Different assumptions about deficits and inflation account for the difference between the Administration's projected path of interest rates and the future interest rates that are now implied by the financial futures markets and the yields on securities of different maturities. Sharply falling deficits should reduce the real interest rate while declining inflation should shrink the inflation premium in the market interest rate. The Administration's projection of a 5.0 percent interest rate on 91-day Treasury bills in 1989 implies a real interest rate of 1.8 percent, a level that is actually higher than the 1.3 percent average real T-bill rate during the last thirty years. In contrast, the financial markets are currently less sanguine about the effects of deficits and inflation on interest rates. The Treasury bill futures market and the yield curve for Treasury securities implies that financial markets expect the interest rates on Treasury securities to rise over the next few years.

In summary, the difference between the Administration's economic projections and most private forecasts is basically due to conflicting assumptions about future fiscal and monetary policies rather than to any difference of opinions about the way that the economy operates. I believe that if most private economists accepted the premise of sharply declining deficits and a sound monetary policy, they would forecast more robust growth and lower inflation. Similarly, if we had to base our projections on the assumption that Congress would not enact this year's budget recommendations and a further major deficit reduction package in 1985 and that the Federal Reserve would not pursue a sound monetary policy over the coming years, we would be forced to project slower growth and rising inflation.

Long-Term Focus

The second important difference between the Administration's economic projections and private forecasts is that our strategy is to focus on the overall trend in real GNP and not to forecast year-to-year fluctuations. We forecast a four percent rate of growth of real GNP in each year from 19 through 1988 even though we recognize that there will be some years in which real growth exceeds four percent and others in which it is less than four percent. We do not claim to have the ability to forecast these year-to-year oscillations in the future.

I would emphasize, as I did last year, that such year-to-year detail is unnecessary for the purpose of shaping the budget and guiding the evolution of government programs. If economic activity exceeds our projections in some future year, the resulting budget deficit in that year will be smaller than

we forecast; conversely, if the economy is weaker than we project in some future year, that year's deficit will be larger. Such cyclical fluctuations in the deficit along the path toward budget balance are not inappropriate.

The experience of the past year has served to underline the inherent uncertainty of all economic forecasts. The extent to which the uncertainty of a forecast impairs its usefulness depends on the purpose for which the forecast is intended. A business that wants to use an economic forecast to plan its near-term production and inventories would need a forecast that provides quite accurate short-term detail. A government that is adjusting monetary and fiscal policies continuously in an attempt to prevent unwanted fluctuations in real GNP would also need more accurate forecasts than we believe are possible.

The primary purpose of the Administration's economic projections is to serve as a basis for long-term budget planning. We believe that the accuracy and nature of our projections are adequate to that task. The projections clearly imply that substantial legislative changes to reduce the deficit will be needed in future years if the budget is to be moved into balance or near balance before the end of the decade.

Reducing the Deficit

To conclude this testimony, I want to comment briefly on the President's proposal for bipartisan negotiations on the budget. I believe that rapid completion of these negotations and enactment of tax and spending proposals is a crucial first step in dealing with the deficit. A downpayment of this sort and a commitment to future action to reduce deficits signifi-

cantly would be clear evidence that the Congress and the Administration can work together to reduce prospective budget deficits. It would be a welcome indication that the seriousness of the deficit problem is recognized and that the remaining problem will be dealt with rapidly after the election. Nothing could better strengthen the confidence of financial investors and improve the prospects for a sound recovery with declining interest rates.

SUMMARY OF 1985 BUDGET REQUEST

Chairman HATFIELD. Mr. Stockman.

Mr. STOCKMAN. Mr. Chairman, let me just briefly summarize a couple of points in my testimony that I want to especially call to the attention of the committee. I think by now you are all familiar with the budget totals. They are provided on page 2 of my testimony.

The reason why the numbers are at the level that they are is that they reflect what we propose to do by way of savings and changes to reduce the deficit in 1985 and then the magnitude of the challenge that we are all going to have to face and cope with next year and in the succeeding years.

RECOMMENDATIONS TO APPROPRIATIONS COMMITTEE

I would like to focus in particular on what we are recommending to the Appropriations Committee for 1985 because, regardless of how the work on the overall proposition of the aggregate budget condition and the size of the deficit, the real work on this committee will be to sort through the whole array of appropriated defense and non-defense alike that we propose.

Although we haven't come to agreement on everything over the last 3 years, I think we have come to agree quite clearly and firmly that we cannot hold an appropriations committee in the House and the Senate responsible for the cost of entitlement programs and other mandatory programs, even though some of those are appropriated and appear in your individual appropriation bill totals.

ADMINISTRATION RECOMMENDATIONS

I can summarize what I have tried to do. Beginning on page 3, as indicated, is our request for fiscal year 1985 that is pending before this committee for discretionary programs in the 13 annual appropriations bills.

NON-DEFENSE SPENDING

If I can divide it into defense and non-defense, on page 3 we indicate that for the 11 non-defense bills, we are recommending $133 billion in new budget authority, and in addition to that, about $38.6 billion in

things that you control that are not scored as new budget authority but are in the discretionary purview of this committee. By that I mean loan and obligation limitations, limitations on things like highways and airports, some administrative expense limitations for Social Security, administrative costs and so forth, that come before the Appropriations Committee.

So overall, our request is nearly $172 billion in the 11 non-defense bills for discretionary action that this committee will have to review, accept or reject, sort through and change if you come to contrary decisions about the appropriate priorities and distributions.

This is a pretty tight budget. I know for comparison that the amount actually appropriated and signed into law, including the pay supplementals that we need for the pay increases that have been granted in 1984 was $170.5 billion, so we have only come up $1 billion, or less than 1 percent, overall in our recommendation for 1985.

DISCRETIONARY SPENDING AUTHORITY

On page 5 I called to your attention the distribution of this $172 billion in discretionary spending authority that we have recommended to the Committee among the 11 appropriation bills.

As you can see, we are asking for more than last year for Commerce, Energy and Water, HUD, DOT, and Foreign Operations. We are requesting less for Labor/HHS and Agriculture. The Treasury and Interior bills requests for discretionary spending is about the same in dollar terms as was appropriated in 1984.

DEFENSE SPENDING

Now, on the defense side I tried to address that in the back part of my testimony, but just to again highlight what I think is a key point that bears on the contentious arguments that we may have about the proper defense funding level, I am going to ask you to turn to page 30. I have suggested here that the 1985 request, even though in pure numbers terms appears to be large—a $47 billion increase in budget authority for 1985 relative to the $258 billion that was appropriated in 1984, about a 13 percent real growth after inflation—that when we look at the details and content of this request closely you will see the dollars needed in 1984 to fund the defense program that has been approved on a joint basis with the Congress over the last 3 years.

I think these figures here indicate that beginning about 1980 we all agreed or came to the conclusion that we were in serious trouble with almost every component of our defense establishment; that a major buildup was going to be needed for a variety of things: readiness, pay, improving the Navy, rectifying the strategic imbalance that was opening up, modernizing many of our conventional systems. We have launched, over the last 3 years, a major buildup.

From 1982 to 1984, we requested $75- billion in defense budget authority and the Congress has agreed to 94 percent of that, roughly $710 billion, over those 2 years.

Moreover, even of the $45 billion that you have reduced from our request over the last 3 years, a substantial part of that, about 40 percent, consists merely of bookkeeping changes regarding the inflation rate to assume for certain weapons systems, fuel costs and so forth, as well as other purely financing changes that were made by way of dollar reductions in the Defense Appropriation bill.

The actual program differences over the course of those 3 years between the Congress and the administration amount to less than 4 percent of what we requested over the period or about $27 billion out of the request of $750. So I would say that the record is pretty clear that over the last 3 years, we have launched major efforts that cost more, to pay, to rebuild and improve the readiness and to launch a whole variety of strategic and conventional systems.

If you look at the numbers in the 1985 request closely, you will see that most of the $305 billion is needed to fund the 1985 installment of everything that has been approved and jointly agreed to over the last 3 years at this table.

I am sure there is still going to be a large argument over the appropriate size of real growth, over the appropriate dollar level or amount of increase for 1985. But I hope that we can move ourselves away from these free-swinging arguments over a single number called the real growth rate and focus on what it will actually cost to continue in 1985 the program that we have jointly launched over the last 4 years. It will be close to what we have recommended.

So those are my introductory remarks, Mr. Chairman, and we are all very happy to begin to hear your questions and try to respond.

[The prepared statement of Mr. Stockman follows:]

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET

PREPARED STATEMENT OF HON. DAVID A. STOCKMAN
DIRECTOR

1985 BUDGET OVERVIEW

The President's 1985 Budget represents a modest further step on the long and difficult road to fiscal balance that lies ahead. It builds upon and extends the far-reaching progress made thus far in re-ordering national priorities and restraining the growth and size of domestic government. Major features of the 1985 Budget include:

- o continuing through the end of the decade the virtual freeze on constant dollar domestic spending that has been in place since 1981;
- o continuing the necessary realignment of budget priorities toward defense, national interest programs and other core purposes of government;
- o preserving the economically essential individual tax rate reductions, business depreciation reforms and indexing provisions enacted in 1981, while pointing the way toward future tax code reform and base broadening;
- o stabilizing the projected budget deficit over the next several years at about $180 billion, resulting in a decline in the deficit share of GNP from 6.0% in 1983 to 3.9% by 1987;
- o reserving for next year the large structural reforms in major budget components that will be needed to bring spending and revenues back into alignment -- thereby preserving non-inflationary real economic growth over the longer term.

FY 1985 Proposed Budget
(billions of dollars)

	1984 Est.	1985	1986	1987
o Outlays	853.8	925.5	992.1	1,068.3
o Receipts	670.1	745.1	814.9	887.8
o Deficit	-183.7	-180.4	-177.1	-180.5

31-443 O - 84 - 4

Average Annual Increase, 1984-87:

- o Receipts 9.8%
- o Outlays 7.8%
  - o Defense 13.6%
  - o Debt Service 6.5%
  - o Non-Defense Programs 5.0%

Deficit Share of GNP:

- o 1983 Actual ..... -6.0%
- o 1984 Estimate ..... -5.2%
- o 1985 Budget ..... -4.6%
- o 1986 Budget ..... -4.2%
- o 1987 Budget ..... -3.9%

A. NON-DEFENSE APPROPRIATIONS REQUEST FOR FY 1985

For the eleven appropriations bills excluding Defense and Military Construction, the FY 1985 request for discretionary spending authority is $171.5 billion -- an increase of $1 billion from the 1984 enacted level.* Thus, on an overall basis, the 1985 request embodies the strict funding restraint that has been central to the Administration's fiscal policy since 1981.

The $171.5 billion 1985 request consists of spending authority within the direct control of the appropriations committee. This includes new budget authority for $132.9 billion in annually funded discretionary programs and proposed obligational authority, lending and administrative expense limits of $38.6 billion. These amounts compare to the enacted 1984 levels as follows:

	1984 Enacted	1985 Request	Difference Amount	Difference %
o New budget authority	125,902	132,931	+7,029	+5.6%
o Obligation/loan/expense limits	44,650	38,602	-6,048	-13.5%
Total discretionary spending authority	$170,552	$171,533	+981	+0.6%

* Adjusted for pending pay supplementals necessitated by 3.5% pay increase of January 1, 1984.

These amounts, of course, do not represent the entire 1985 request pending before the appropriations committee. Additional new budget authority of $123.4 billion is requested for activities essentially beyond the direct control of the appropriations committee. These programs include appropriated entitlements such as food stamps and medicaid, mandatory appropriations, subsidized housing and pro forma amounts needed to replenish revolving funds such as the CCC and the Farmers Home Insurance funds. As has been the case in previous years, the Administration believes that it is not appropriate to hold the committee accountable for these non-discretionary amounts and that appropriations scorekeeping should focus on the sum of new budget authority and other discretionary spending authority requested for each of the 11 non-defense bills. A reconciliation between the 1985 request for total new budget authority and the $170.6 billion in discretionary spending authority highlighted above follows:

	Amount (millions)
o Total new budget authority, 1985 request	256,337
o Deduct non-discretionary new budget authority	-123,406
o Add discretionary obligation/loan/ expense limits	+38,602
o Net discretionary spending authority, 1985 request	171,533

While the overall request for discretionary spending authority is only slightly above the 1984 enacted level, the Administration continues to press for a major realignment of priorities within to non-defense total. Compared to 1984 enacted levels:

- o the Commerce, Energy and Water, HUD, DOT and Foreign Operations requests represent significant increases;
- o the request for Agriculture, Labor-HHS and D.C. is significantly reduced from 1984 enacted levels;
- o the Treasury and Interior requests are about level with the 1984 enacted amount.

Following the table, the request figures and highlights of major changes from the 1984 enacted amounts are presented for each bill.

1985 REQUEST, NON-DOD ANNUALLY FUNDED SPENDING AUTHORITY 1/

Appropriations Bill	1985 Request	Compared to 1984 Enacted 1/ Amount	Percent
	(dollars in millions)		
1) Agriculture	$13,926	-$3,846	-22%
2) Commerce/State	11,331	+899	+9%
3) District of Columbia	503	-98	-16%
4) Energy & Water	15,790	+1,457	+10%
5) HUD/Independents	29,761	+1,679	+6%
6) Interior	8,038	+4	---
7) Labor/HHS	36,507	-1,577	-4%
8) Legislative	1,700	-63	-9%
9) Transportation	28,040	+1,460	+6%
10) Treasury/Postal	8,918	+243	+3%
11) Foreign Operations ..	18,020	+823	+5%
Total	171,533	+981	+0.6%

1/ Includes obligational and loan limitations as well as new budget authority.

I. AGRICULTURE AND RELATED AGENCIES

Bill Summary

1985 Discretionary Spending Request

1) New budget authority	6,627	
2) Loan limitations	7,299	
3) Total discretionary authority ..	13,926	
Compared to 1984 Enacted Bill		
4) New budget authority	-228	(- 3%)
5) Loan limitations	-3,618	(-33%)
6) Total discretionary authority	-3,846	(-22%)
Reconciliation to Total New Budget Authority		
7) Total discretionary authority	13,926	
8) Minus loan limitations	-7,299	
9) Plus mandatory B.A.	+19,418	
10) Total new budget authority	26,045	

Reductions from the 1984 Enacted Bill:

Extension Service: $299 million request is down $35 million or 10% due to low priority program terminations.

Agricultural Conservation, Emergency Conservation & Water Bank: $80 million request is down $126 million or 61% via consolidation of ACP programs.

REA Administration Expenses: Zero funding is proposed due to proposed $30 million user fee to cover expenses.

Soil Conservation Service: $475 million request is down $127 million or 21% due to zero funding of resources conservation and a 51% cut in watershed and flood prevention activities.

APHIS: $225 million request is down $45 million or 17% due to redesign of the brucellosis eradication program.

Food Donations: $24 million request is down by $161 million or 87% due to transfer of Elderly Feeding program to HHS, direct CCC donations and the availability of $18 millon in carryover B.A.

Small FmHA Housing and Development Grants: Zero funding compared to $26 million in 1984 for domestic farm labor, mutual and self-help housing, low-income repair grants and community fire protection, to be financed through low-interest loans rather than grants.

Rural Housing Insurance Fund: $2.3 billion request is down $965 million or 29% due to cutback of middle-income ownership subsidies and fewer rental subsidy units.

Rural Development Fund: $350 million request is down by $50 million or 12% due to reduced water, sewer and facilities loans and elimination of the Business & Industry loan programs.

REA Direct Loans: $575 million request is down $525 million or 48% because 5% subsidized rates are not needed or justifiable.

REA Guaranteed Loans: $1.3 billion request is down $2 billion or 61% because new loans are being directed to project completions only.

Major Program Increases From 1984 Enacted:

PL-480: $1,319 million request is up $267 million or 25% due to declining revolving fund receipts and slight increases in program volume.

Federal Crop Insurance Administration Costs: $227 million request is up $27 million or 14% due to projected increases in subscription volume.

WIC: $1,277 million will support a 2.7 million annual caseload compared to 2.9 million at present which will require a 1984 supplemental.

All Other Programs Nearly Level Funded

1985 Request: $5,455 billion request is within 1% of 1984 enacted funding of $5,381 million for:

- o Agricultural Credit
- o Rural Telephone
- o FDA
- o Salary & Expense Accounts of USDA, FLMA, ASCS
- o Food Safety Inspection
- o Agricultural Research
- o Foreign Agricultural Services

Effect on Discretionary Program Outlays Compared to Current Services Baseline

	1985	1986	1987
Current Services Baseline	7,578	7,754	7,886
Effect of 1985 Budget	-288	-799	-978

II. COMMERCE, STATE, JUSTICE & JUDICIARY

Bill Summary

1985 Discretionary Spending Request

1) New Budget Authority.....	10,891	
2) Loan Limitations.....	440	
3) Total discretionary authority.....	11,331	
Compared to 1984 Enacted Bill		
4) New Budget Authority.....	+459	(+4%)
5) Loan Limitations.....	+440	(n/a)
6) Total discretionary authority.....	+899	(+10%)
Reconciliation to Total New Budget Authority		
7) Total Discretionary Authority.....	11,331	
8) Minus Loan Limitations.....	-440	
9) Plus Mandatory/Pro Forma Authority...	144	
10) Total New Budget Authority.....	11,035	

Reductions from 1984 Enacted Bill

Economic Development Grants -- No request compared to $240 million FY 1984 enacted level -- reflects continued Administration view that EDA activities simply move jobs around the country, rather than creating them.

NOAA Operations, Research & Facilities -- $886 million request is down $98 million -- or 10% -- due to adjustment for excessive funding levels provided in FY 1984 bill.

OJARS Justice Assistance Grants -- $134 million request is down $63 million, or 32% from FY 1984 level, reflecting continuation of earlier proposals to eliminate grant assistance under old OJARS authorities.

Legal Services Corporation -- No request compared to FY 1984 appropriation of $275 million, reflecting continued administration view that legal aid activities can be more effectively and responsively funded under general social services assistance to the States.

Major Program Increases from FY 1984 Enacted

Justice Department Legal Activities: $204 million request is up $43 million, or by 27% due to dramatically expanded caseloads for litigation in which the United States is at interest.

United States Attorneys & Marshalls: $426 million request is up $46 million or by 12%, reflecting higher protective services and bailiff costs associated with increasing Federal court activity.

FBI, DEA, OCDE: $1,495 million request is $50 million or 3%, reflecting consolidation of large increases in 1983-84 and continued high priority of law enforcement activity.

Immigration & Naturalization Service: $575 million request is up $65 million or 13% due to increased staff and support for border security initiatives.

Federal Prison Construction: $83 million request is up $35 million or by 73% due to the financing needed to pursue prison capacity expansion initiatives.

State Department Construction & Operating Accounts: $1,600 million request is up $255 million or 19% due to embassy and consulate reporting, communications and security requirements, and enhanced mission staffing worldwide.

Micronesian Compact of Free Association: A new request of $295 million is made to provide financing required by the negotiated compact with the Marshall Islands and the Federated States of Micronesia.

United States Information Agency: Overall request of $849 million is up $183 million, or by 28%, to support the Voice of America construction program, staffing expansions, and expanded resources for the National Endowment for Democracy.

All Other Programs Nearly Level Funded

1985 Request: $4,338 request is equivelant to 98% hold harmless funding for such activities as:

- Judiciary accounts
- Census Bureau
- Minority Business Development
- Contributions to International Orgs.
- EEOC
- Commerce Dept Administration
- International Trade Adm.
- NOAA Fisheries Programs
- National Bureau of Standards
- Maritime Administration
- Civil Rights Commission
- FTC

Effect on Discretionary Program Outlays Compared to Current Services Baseline

	1985	1986	1987
Current Services Baseline	10,840	10,990	11,461
Effect of 1984 Budget	+215	-201	-253

III. DISTRICT OF COLUMBIA

Bill Summary

1985 Discretionary Spending Request

1) New Budget Authority.....	503	
2) Loan Limitations.....	---	
3) Total discretionary authority.....	503	

Compared to 1984 Enacted Bill

4) New Budget Authority.....	-97	(-16%)
5) Loan Limitations.....	n/a	
6) Total discretionary authority.....	-97	(-16%)

Reductions from 1984 Enacted

Loans to the District of Columbia: No request in FY 1985, following $115 million FY 1984 level. Request assumes finalization of agreement to ensure access of the District government to private credit markets.

Major Program Increases from 1984 Enacted

Federal Payment to the District of Columbia: Request of $503 million represents an $18 million increase, or 4% above the 1984 enacted level.

Effect on Discretionary Program Outlays Compared to Current Services Baseline

	1985	1986	1987
Current Services Baseline	598	609	628
Effect of 1984 Budget	-86	-102	-117

IV. ENERGY & WATER

Bill Summary

1985 Discretionary Spending Request

1) New Budget Authority.....	15,790
2) Loan Limits.....	---
3) Total discretionary authority...	15,790

Compared to 1984 Enacted Bill[1/]

4) New Budget Authority.....	+1,457
5) Loan Limits.....	---
6) Total discretionary authority...	+1,457

Reconciliation to New Budget Authority

7) Total Discretionary authority.....	15,790
8) Less Loan Limits.....	---
9) Plus mandatory/pro forma authority.	---
10) Total new budget authority.....	15,790

1/ Includes pay and other requirements. For comparability, excludes uranium enrichment, Energy Department reimbursable programs, and Bonneville.

MAJOR AGENCY REQUESTS

Army Corps of Engineers: $2,716 million request is up $102 million or 4%. Represents small reductions in general investigations and construction and $107 million or 9% increase for operations and maintenance.

Bureau of Reclamation: $1,078 million request is up $115 million or 12%, and reflects recent redirection of policy goals within overall resource development activity.

Atomic Energy Defense: $7,805 million request is up $1,250 million or 19%. Increase driven by strategic modernization program, weapons production requirements and need for facilities upgrade and refurbishment.

Energy General Science: $746 million request is up $108 million or 17% reflecting continued Administration emphasis on basic science and technology.

Energy Supply, R&D Activities: $2,037 request is nearly level with $2,000 million 1984 enacted appropriation. Provides higher request than previously for renewable energy R&D, and continuation of nuclear programs at current levels.

Nuclear Regulatory Commission: $468 million request is level with 1984 enacted appropriation.

Appalachian Regional Development: No request compared to 1984 appropriation of $154 million. The Administration continues to believe that the development programs should be terminated, but provides $80 million in another account for highway system completion.

Energy Information, Policy and Regulation: $138 million request is down $228 million or 62%. While 1984 program level will be continued, balance will be funded from revenues from sale of publications.

Power Marketing Administrations: $138 million request is up $61 million or 24% primarily due to increase for Western Area Power Administration construction activities.

Nuclear Waste Disposal Fund: $327 million request is up 3% from 1984 enacted appropriation to support continued research development and implementation of civilian reactor waste program.

Effect of Discretionary Program Outlays Compared to Current Services Baseline

	1985	1986	1987
Current Services Baseline	14,825	15,230	15,196
Effect of 1984 Budget	+620	+1,332	+2,198

V. HUD/INDEPENDENT AGENCIES

Bill Summary

1985 Spending Request		
1) New Budget Authority[1]	29,094	
2) Loan & Obligation Limits	667	
3) New discretionary authority	29,761	
Compared to 1984 Enacted Bill		
4) New Budget Authority	+1,071	(+4%)
5) Loan & Obligation Limits	+608	(+1,031%)
6) New discretionary authority	+1,679	(+6%)
Reconciliation to Total New Budget Authority		
7) Total discretionary authority	29,761	
8) Less Loan & Obligation Limits	-667	
9) Plus Mandatory & Proforma BA[1]	26,237	
10) Total New Budget Authority	55,331	

Reductions from 1984 Enacted Bill

Solar Bank: No request; prior appropriation $25 million.

Rental Construction and Rehabilitation: No request; for 1985 due to release of $615 million in 1984 funds under the terms of the IMF/Housing Agreement.

Veterans Job Training: No request: Last year's funding of $130 million no longer justified as program separate from ongoing JTPA activities.

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[1] Line (1) excludes, and line (9) includes, budget authority for subsidized housing of $5,866 million.

Major Program Increases from 1984 Enacted

Environmental Protection Agency: Systematic program increases:

-- Energy-related R&D, at $44 million, up $18 million or 69% to support acid rain initiatives.

-- Salaries & Expenses, at $639 million, up $61 million or 11%;

-- Superfund, at $640 million, up $230 million or 56% to maintain toxic waste clean-up at most rapid feasible pace.

NASA: $7,491 million request is up $274 million or 4% with principal increases in R&D for space flight (space station start) and space science, applications and technology.

Veterans Medical Care: At $8,767 million, up $578 million or 7% to cover rising expenses and demand.

VA Major Construction: Requested at $620 million, an increase of $274 million, or 79%, in order to fund major facilities rennovations and replacements necessitated by growing demand for medical care.

FEMA Civil Defense: At $320 million, up $85 million or 36% to carry-out Administration emergency preparedness initiatives.

NSF Research: At $1,308 million, up $167 million or 15% in keeping with Administrations strong emphasis on basic science research.

All Other Programs Nearly Level-Funded

1985 Request: $9,932 million is only slight increase over level provided in FY 1984 for such activities as:

- o CDBG
- o EPA Construction
- o UDAG
- o VA Operations

Effect on Discretionary Program Outlays Compared to Current Services Baseline

	1985	1986	1987
Current Services Baseline	28,847	28,442	28,337
Effect of 1984 Budget	+522	+1,755	+3,678

VI. INTERIOR & RELATED AGENCIES

Bill Summary

FY 1985 Discretionary Spending Request

1) New Budget Authority.....	8,022	
2) Loan/Obligation Limits.....	16	
3) Total discretionary spending.....	8,038	

Compared to FY 1984 Enacted

4) New Budget Authority.....	+1	(n/a)
5) Loan/Obligation Limits.....	+3	(+23%)
6) Total discretionary spending.....	+4	(n/a)

Reconciliation to Total New Budget Authority

7) Total discretionary spending.....	8,038
8) Less Loan/Obligation Limits.....	-16
9) Plus Mandatory/Pro Forma BA.....	74
10) Total New Budget Authority.....	8,096

Public Lands and Resource Management: Essentially Level Funding for Operations and Construction

	1985 Request	Difference from 1984 Amount	Difference from 1984 %
o National Forest System & Construc..	1,291	+152	+13%
o BLM including PILT & Oregon/Calif..	508	-9	-2%
o Minerals Management Service	167	+3	+2%
o Geological Survey	382	---	---
o Fish & Wildlife, Mgt. & Construc ...	301	---	---
o National Parks: Operation & Construc	703	+44	+7%
Total, Operations & Construction ...	3,352	+190	+6%

Public Land Acquisition and Special Programs: Major Reductions Consistent with Limited Budget Resources

	1985 Request	Difference from 1984 Amount	Difference from 1984 %
o State/Private Forestry	26	-35	-57%
o Forest Land Acquisition	10	-29	-74%
o BLM Land/Mineral Acquisition	11	-6	-35
o FW&S Land Acquisition	58	+13	+29
o Urban Parks	0	-9	-100
o NPS Land Acquisition	130	-104	-44
o Historic Preservation	0	-27	-100
Total, Acquisition & Special	235	-197	-46%

Other Major Program Increases

Strategic Petroleum Reserve: $447 million request is up $288 million or 181%, reflecting construction of Big Hill storage facility.

Surface Mine Reclamation and Enforcement: $361 million request is up 7%, primarily reflecting increase for abandoned mine reclamation fund.

Bureau of Indian Affairs and DoEd Education: $997 million is up 1% reflecting continuation of existing program levels in most instances.

Smithsonian and Related: $236 million request is up 15% to cover cost increases and renovation activities.

Other Major Program Decreases

Fossil Energy R&D: $203 million request is down $57 million or 22%. Request exceeds prior years but is consistent with Administration goal of terminating high-cost, commercial type projects.

Energy Conservation: $382 million request is down $49 million or 11%. In FY 1985, $238 million of financing for this account is requested by transfer from proposed HHS "petroleum overcharge restitution fund."

National Endowments for Arts and Humanities: $269 million request is down 11%, reflecting continuing Administration attempt to constrain lower priority expenditures.

Territorial Affairs: $150 million request is down $41 million or 22% due to realignment of economic support consistent with Micronesia Compact.

Indian Health Service: $742 million request is down $82 million or 10% primarily due to zero construction request after large appropriations in Jobs Bill and 1984 Interior bill.

Bureau of Mines and Naval Petroleum Reserve: $394 million request is down 11% due to reduced funding requirements and paring low priority activities.

Effect on Discretionary Program Outlays Compared to Current Services Baseline

	1985	1986	1987
Current Services Baseline	8,828	9,171	9,377
Effect of 1985 Budget	-387	-583	-986

VII. LABOR/HHS/EDUCATION

Bill Summary
(millions)

1985 Discretionary Spending Request	Amount	
1) New Budget Authority.....	28,963	
2) Loan/Obligation Limits.....	7,544	
3) Total discretionary authority.....	36,507	
Compared to 1984 Enacted 1/		
4) New Budget Authority.....	-1,442	(-5%)
5) Loan/Obligation Limits.....	-135	(-8%)
6) Total Discretionary authority.....	-1,577	(-5%)
Reconciliation to Total New Budget Authority		
7) Total discretionary authority.....	36,506	
8) Less Loan/Obligation Limits.....	-7,544	
9) Plus Mandatory/Pro Forma BA.....	70,897	
10) Total New Budget Authority.....	99,859	

1/ Includes pay and other requirements; excludes ETA forward funding.

Major Programs are Essentially Level Funded

	1985 Request	Difference from 1984 Amount	%
o National Institutes of Health	$4,566	$+90	+2%
o ADAMHA Research/Training	373	-12	-3%
o Low-Income Energy	1,875	0	0
o Employment and Training	3,611	-8	--
o Older Americans Employment	317	0	0
o Disadvantaged Eduction	3,480	-7	--
o Handicapped Education	1,214	-25	-2%
o Vocational/Adult Education	838	0	0
o Head Start	995	-1	--
o Older Americans Act Services	658	-17	-3%
o Child Welfare	169	-12	-7%
o Primary Care Block Grant	534	+11	+2%
o ADAMHA Block Grant	473	+11	+2%
o Preventative Care Block Grant	890	+2	+2%
o Maternal & Child Health	480	+8	+2%
o Medicare Administrative Expense	1,131	+60	+6%
o Social Security Admin. Expense	3,725	-24	-1%
o Total	$25,329	+76	+0.3%

Major Reductions from 1984 Enacted Bill Appropriations

Refugee Assistance: $360 million request is down $155 million or 30% from prior year, reflecting system reforms and lower new refugee caseloads.

Community Services Block Grant: $3 million request will support close-out activities assuming no funding for program activities, compared to last year's $352 million level.

Work Incentives: No request, compared to $271 million funding level last year, reflecting transfer of program responsibilities to State under JTPA.

General Departmental Management: $133 million request, a $25 million reduction (19%) from prior appropriations, reflect economies due to organizational changes resulting from Grace Commission recommendations.

State Employment Service and Unemployment Insurance Administrative Costs: $2,630 million request is down $706 million or 19% due to lower projected unemployment and workload.

Impact Aid: $507 million request is down $78 million or 13%, reflecting termination of Part B funding.

Student Financial Aid: $3,654 million request is down $333 million or 8% due to improved targeting toward low-income students and zero request for campus-based programs.

Other Higher Education: $252 million request is down $156 million or 38%, reflecting elimination of low-priority progams and restructuring of matching requirements.

Libraries: No request for this categorical support program, compared to FY 1984 enacted level of $87 million.

Major Program Increases

Elementary & Secondary Education State Block Grants: Request of $729 million, an increase of $201 million or 38% over 1984 level, reflects funding for increased educational quality improvement initiatives.

Special Institutions: Request of $241 million, a $9 million increase over 1984, will fund expanded support for Howard University and other special Federally-supported institutions.

Effect on Discretionary Program Outlays Compared to Current Services Baseline

	1985	1986	1987
Current Services Baseline	38,537	39,894	41,341
Effect of 1985 Budget	-1,463	-3,037	-4,182

VIII. LEGISLATIVE BRANCH

Bill Summary

1985 Discretionary Spending Request

1) New Budget Authority.....	700	
2) Loan/Obligation Limits.....	---	
3) Total discretionary authority.....	700	
Compared to 1984 Enacted[1/]		
4) New Budget Authority.....	-63	(-8%)
5) Loan/Obligation Limits.....	---	
6) Total discretionary authority.....	-63	(-8%)
Reconciliation to Total New Budget Authority		
7) Discretionary spending request.....	700	
8) Less Loan/Obligation Limits.....	---	
9) Plus Mandatory/Pro Forma BA.....	928	
10) Total New Budget Authority.....	1,628	

1/ Includes pay and other requirements.

- The Administration budget merely transmits the legislative agency requests without change under long-standing practice. The only significant discretionary increase is for GAO -- the request of $329 million is up 21% over 1984.

Effect on Discretionary Program Outlays Compared to Current Services Baseline

	1985	1986	1987
Current Services Baseline	752	759	773
Effect of 1985 Budget	---	---	---

IX. TRANSPORTATION

Bill Summary

1985 Discretionary Spending Request

1) New Budget Authority.....	11,545	
2) Obligation/Lending Limits.....	16,495	
3) Total discretionary authority....	28,040	
Compared to 1984 Enacted Levels 1/		
4) New Budget Authority.....	+589	(+5%)
5) Obligation/Lending Limits.....	+870	(+6%)
6) Total discretionary authority....	+1,460	(+5%)
Reconciliation to Total New Budget Authority		
7) Discretionary spending authority....	28,040	
8) Less Obligation/Lending Limits.....	-16,495	
9) Plus Mandatory/Pro Forma BA.....	+363	
10) Total New Budget Authority.....	11,908	

1/ Includes pay and other requirements

Major Programs Essentially Level-Funded

	1985 Request	Difference from 1984 Amount	Difference from 1984 %
o UMTA Formula Grants & D.C. Metro ...	$2,640	+1	---
o FAA Operations (Incl. Trust Fund) ..	2,722	+123	+5%
o FAA, Research, Engineering	269	+6	+2%
o Coast Guard Operations	1,758	+73	+4%
o Panama Canal Fund	444	+5	+1%
o NHTSA Alcohol Incentive & State Safety Grants	142	+4	+3%
Subtotal	$7,975	+212	+3%

Major Program Increases from 1984 Enacted Level

Highway Trust Fund: $13,975 million obligation limit request is up $766 million or 6% in accordance with STAA authorization rise.

Airport Grants: $987 million obligation limit request is up $187 million or 23% representing full authorization level.

FAA Facilities and Equipment: $1,657 million request is up $907 million or 121%. Proposed jump is designed to off-set 1984 appropriation cut and keep FAA modernizaton program on track envisioned in Authorization Act.

NHTSA Regulatory Operations and Highway Safety Research: $90 million request is up 15% reflecting revised departmental priorities.

Major Program Reductions from the 1984 Enacted Level

Amtrak: $680 million request is down $145 million or 18% due to carry-over funds and reduced subsidy requirements.

Northeast Corridor: No request compared to $100 million in 1985 due to completion of Administration's multi-year funding commitment.

Coast Guard Acquisition and Improvement: $362 million request maintains existing vessel and aircraft modernization program due to carry-over availability of unrequested $699 million 1984 appropriation.

Urban Mass Transit Fund (Section 3): $1,100 million request is down $125 million or 10%, but is consistent with STAA authorization for 1985.

Interstate Transfer Grants -- UMTA: $250 million request is down 15% due for overall fiscal restraint need.

Effect on Discretionary Program Outlays Compared to Current Services Baseline

	1985	1986	1987
Current Services Baseline	26,425	27,423	28,378
Effect of 1985 Budget	-328	-87	-463

X. TREASURY/POSTAL SERVICE

Bill Summary

1985 Request for Discretionary Spending Authority

1) New Budget Authority.....	6,641	
2) Loan/Obligation Limits.....	2,277	
3) Total discretionary authority.....	8,918	
Compared to 1984 Enacted Levels 1/		
4) New Budget Authority.....	+31	(+1%)
5) Loan/Obligation Limits.....	+213	(+10%)
6) Total Discretionary Authority.....	+244	(+3%)
Reconciliation to Total New Budget Authority		
7) Total Discretionary Authority.....	8,918	
8) Less Loan/Obligation Limits.....	-2,277	
9) Plus Mandatory/Pro Forma BA.....	5,311	
10) Total New Budget Authority.....	11,952	

1/ Includes pay and other requirements

Reductions from 1984 Enacted Level

U.S. Customs Service: $602 million request, down $24 million or 4%, from 1984 level. Brings request in line with activity level originally requested in 1984.

Payment to Postal Service: $692 million net request, down $187 million or 21% from prior level, will be more than adequate to meet revenue foregone subsidy and pay transitional liabilities of former Post Office.

Major Increase from 1984 Levels

Federal Buildings Fund: Request of $2,228 million, up $212 million or 10%, will fund construction and modernization activity level commensurate with requested SLUC financing.

Internal Revenue Service: Request of $3,532 million, up 6%, will support taxpayer compliance verification activities directed in recently-enacted and proposed legislation.

All Other Accounts Level or Modestly Increased

1985 Request: $1,864 level is only slightly above $1,827 level enacted in 1984 for such agencies as:

- o Executive Office of the President
- o General Service Administration
- o Office of Personnel Management

Effect on Discretionary Program Outlays Compared to Current Services Baseline

	1985	1986	1987
Current Services Baseline	6,840	6,670	6,736
Effect of 1985 Budget	-258	-431	-369

XI. FOREIGN OPERATIONS

Bill Summary

1985 Request for Discretionary Programs

1) New Budget Authority.....	14,156	
2) Loan/Obligation Limits.....	3,864	
3) Total discretionary authority.....	18,020	

Compared to 1984 Enacted

4) New Budget Authority.....	+5,252	(+59%)
5) Loan/Obligation Limits.....	-4,429	(-1%)
6) Total discretionary authority.....	+823	(+40%)

Reconciliation to Total New Budget Authority

7) Total discretionary authority.....	18,020
8) Less Loan/Obligation Limits.....	-3,864
9) Plus Mandatory/Pro Forma BA.....	+34
10) Total New Budget Authority.....	18,054

Major Reductions from 1984 Enacted Levels

IDA Contributions: $750 million request represents the first U.S. Contribution to a seventh replenishment of IDA funds which is less ambitious than the previous replenishment.

International Organizations and Programs: $242 million request, down $72 million or 23% from last year's level, reflects general restraint on voluntary contributions to multilateral programs.

Major Program Increases

Central American Aid: Because the bipartisan commission report on Central America had not been reviewed when the budget was completed, $750 million, not broken down by program, was put into the budget to reflect the probable magnitude of incremental aid to the region.

Economic Support Fund: $3,067 million request is up $110 million or 4% reflecting on-going requirements of U.S. foreign policy objectives in the Middle East, Africa, East Asia and Latin America.

Military Assistance & IMET: $861 million request, is up $300 million or 53%, reflecting increased costs for military base access abroad, training and other security requirements.

Foreign Military Sales Credit: $5,115 million request, up $3,800 million from last year's on-budget appropriation, reflects a decision to move FMSC program on-budget.

Guarantee Reserve Fund: $274 million request would replenish funds which provide reserves against defaults in prior years' off-budget FMSC loans.

Inter-American Development Bank: $151 million request, up $33 million or 28%, would return to negotiated funding levels for the Bank and make the first U.S. contribution to a new program to assist the region's private sector.

Asian Development Bank: $157 million request, up $44 million or 39% from last year's level, would return to negotiated funding levels, cut in 1984, and clear up longstanding arrears.

International Bank for Reconstruction & Development: $110 million request, up $30 million or 38% from 1984 level, would return to negotiated annual funding levels in the Bank.

Functional Development Assistance: Request of $1,409, up $67 million or 5% from prior level, due to increased costs of U.S.' development effort in the third world.

Economic Policy Initiative for Africa: A request of $75 million would fund the first year of a planned $500 million 5-year effort to promote economic policy reform in Africa.

All Other Programs Level-Funded

1985 Request: $4,912 for other foreign assistance activities only slightly above $4,891 enacted level, implying essentially level funding for following activities:

- o African Development Bank and Fund
- o African Development Foundation
- o Inter-American Foundation
- o Peace Corps
- o International Disaster Assistance
- o Refugee Assistance
- o Export-Import Bank

Effect on Discretionary Program Outlays Compared to Current Services Baseline

	1985	1986	1987
Current Services Baseline	9,176	9,316	10,046
Effect of 1985 Budget	+2,872	+3,905	+4,269

B. DEFENSE APPROPRIATIONS REQUEST

The President's 1985 budget request represents a continuation of the necessary defense build-up begun on a bipartisan basis in FY 1981. Progress thus far is substantial:

- o the 1984 enacted appropriations bills represent an increase of $116 billion or 82% from the inadequate 1980 level;
- o real defense purchasing power has risen 41% -- reversing the deep decline that occured in the 1970s;
- o major progress in boosting pay, improving retention, recruitment and training, restoring readiness levels, correcting the strategic imbalance and modernizing conventional weapons system has been made.

The 1985 DOD request totals $305 billion and is comprised as follows:

	(millions)
o Defense Appropriation	$292,101
o Military Construction	10,319
o Pay Raise Supplemental	3,087
o Receipts and Other	-507
o DOD Total B.A. Request	$305,000

The 1985 request represents the level of funding needed to continue the programs and objectives ratified and supported by the Congress since FY 1981. While the proposed $47 billion budget authority increase, representing 13% real growth over the 1984 enacted level, may appear to be large in aggregate terms, the programmatic details behind it largely represents follow-on funding for efforts broadly supported by Congress in the last four budget rounds. Specifically, major components of the requested increase include:

- o a $3.1 billion increase for <u>military and civilian pay raises</u>. In 1984, Congress insisted on a 4% pay increase in lieu of the Administration proposed freeze;
- o a $1.9 billion increase for the 1985 installment of <u>major strategic systems</u>, included B-1, the MX-small missile compromise plan, Trident II, air-launched cruise missiles and the advanced bomber. All of these systems have received strong Congressional endorsement over the past several years;
- o a $13.8 billion increase for <u>major conventional system modernizations</u> including F-14s, -15s, -16s and -18s, the M-1 tank, Bradley fighting vehicle and AH-64 attack helicopter, Aegis ships and support ships to complement the approved 15 carrier-battle groups, and various air- and sea-lift capabilities

and tactical aircraft. Aside from some differences over the annual quantity mix, all of these systems in their current form have been repeatedly supported in congressional funding bills;

- o a $1.1 billion increase for military retirement including system cost accruals as per the 1984 Congressional amendments;
- o a $5.9 billion increase for basic readiness items including flying and steaming hours, training exercises and maintenance;
- o a $7.6 billion increase for war stocks and peacetime operational reserves of spares and munitions;
- o a $6.7 billion increase for cost of R&D, Military construction and other initiatives delayed or deferred by Congress in FY 84;
- o a $6.7 billion increase for all other items ranging from routine base operations to advanced R&D.

With the possible exception of the last items, these increases represent the 1985 cost of existing Congressional policy. While strong arguments about the precise magnitude of some of these increases can be made by both proponents and opponents, these are differences mainly about timing and the pace of increase -- rather than the fundamental thrust of the defense build-up.

Indeed, the actual pattern of program deferrals, stretch-outs and minor trimmings contained in appropriations bills enacted by Congress over the last three years demonstrates this. As is shown in the table below, enacted appropriations over 1982-84 have totaled 94.2% of the Administration's request. Moreover, nearly 40% of the reduction has been attributable to pay raise and retirement pay differences, inflation assumptions and other purely financing issues. Actual program reductions have averaged only $10.4 billion or less than 4% during the last two years.

OUTCOME OF DOD APPROPRIATIONS PROCESS, 1982-84
(Budget Authority, in billions of dollars)

	1982	1983	1984	Total
o Administrations's Request	221.8	257.5	273.4	752.7
o Pay, Inflation, Financing Changes ..	-2.9	-8.0	-5.4	-16.3
o Net Program Deferrals or Reduction	-6.6	-10.9	-9.9	-27.4
o Total Reduction	-9.5	-18.9	-15.3	-43.7
o Total Enacted as % of Request	95.7%	92.7%	94.4%	94.2%
o Program Reduction as % of Request	3.0%	4.2%	3.6%	3.6%

While these figures show that actual programmatic differences have been modest at the completion of the legislative cycle, the initial "numbers debate" has been highly contentious in the last year or two. In part, this stems from the unfortunate practice of debating the "real growth rate" rather than the detailed content of the overall request. This year in particular, the potential for exaggerating the extent of Congressional-Administration differences over defense "real growth" is especially great because of wide variance between Administration and the tentative CBO defense deflators.

The Administration composite defense deflator for FY 1985 is 4.5% reflecting the following elements:

Civilian Pay	3.5%
Military Pay	5.5%
Special Commodities	5.7%
Fuel	0.5%
All Other Purchases	4.7%
Weighted Defense Deflator ..	4.5%

By contrast, it is our understanding that CBO will use a weighted deflator of 7.3%, reflecting different values for the main

defense components. As a consequence, the moderate difference between the 1985 budget authority level contemplated by the Congressional Budget Resolution and the 1985 Administration request will tend to be further exaggerated unless these large differences in the inflation assumptions are reconciled.

Specifically, the 1985 DOD budget authority level contained in the Congressional Budget Resolution is $290 billion or 95.1% of the $305 billion Administration request. This represents nearly an 8% real growth rate when calculated with the Administration defense deflator compared to 13% in the President's request. However, on a CBO deflator basis, the Budget Resolution real growth rate is only 5.2% -- reflecting the higher CBO inflation assumption. It is therefore important that the "real growth rate" be consistently calculated so that the differences are not unnecessarily exaggerated:

	Defense Authority	Real Growth Rate Admin. Deflator	Real Growth Rate CBO Deflator
1985 Administration Request ...	$305	13.0%	10.1%
Congressional Budget Resolution (1985)	290	7.9%	5.2%

In the final analysis, what counts is not the "real growth rate" but the level and distribution of the defense funding bills. As the details of the defense program are examined, it should become increasingly clear that the proposed "increase" simply reflects the 1985 cost of the nation's unavoidable and necessary effort to restore its military capabilities and national security -- an enterprise that was launched on a bipartisan basis in 1981 and which has enjoyed broad Congressional support in all of its significant particulars ever since.

GENERAL QUESTIONING

Chairman HATFIELD. Thank you, gentlemen.

We will adhere this afternoon to a 10-minute rule on questioning and I will alternate between the two sides. I took the names of those who were here at the beginning of the meeting, and we will try to accommodate those in seniority of the schedule who were present at that time.

DEFICITS

Mr. Secretary, I would like to address the subject of the deficit for a few moments. I note that in your testimony, particularly on page 7, as an example, that you have hit very hard on the deficit point as being created primarily or at least, your testimony indicates, primarily by spending increases, ignoring the contribution that may have been made by the tax cut.

Now, at the same time, I note in the testimony of Director Stockman that he is pleased by the spending restraint that has occurred and states that domestic spending has remained virtually frozen in constant dollars since 1981.

That is on pages 1 and 3.

The Congressional Budget Office has recently reported that by 1986, the major spending reductions that will have occurred, almost exactly, will be offset by the increases in defense spending and in the service to the debt. We will have made about a $71 billion reduction to non-defense discretionary programs, and we will have had experienced about a $42 billion increase in military spending and about a $32 billion increase in debt service.

Now, my question is simply this, Mr. Secretary:

SPENDING INCREASES CONTRIBUTING TO DEFICIT

What type of spending increases are you referring to that contribute to the deficit? Are you referring to defense increases, debt service increases, entitlements? I ask because in every source that I have seen, discretionary, non-defense spending has been held nearly in constant dollars in real terms at reduced or below the historical levels.

Secretary REGAN. Mr. Chairman, my reference in my remarks was to the size of Federal spending as a whole. If you take that during the 1950s and 1960s, Federal spending was less than 20 percent of our Gross National Product, it got up into the 20 to 22 percent range during the 1970s, and more recently, has been up in the area of 23 and 24 percent, even up to 25 percent at one point.

As projected in this budget, even out to 1989, it still remains at about the 22 percent level of our Gross National Product in spite of the fact that our Gross National Product in that period of time will have increased tremendously.

Total receipts, on the other hand, during the 1970s, averaged out at around the 19 percent area; 18.5 to 19.5 percent. In 1981, they got up to almost 21 percent. They have backed down now to the 19 percent area again but rise, by 1989, according to our assumptions, back up to about the 20 percent area.

So that is what I am referring to. Now, as far as the tax cuts versus tax increases that have been enacted over the last 3 years, I have a table here which I will submit for the record, but merely to give you an illustration, based upon fiscal year 1985, which is the one under discussion, it is estimated by Treasury that the tax cut of 1981, in fiscal 1985, will reduce revenues by $165 billion.

[The table follows:]

A Comparison of the Tax Increases due to Bracket Creep and the Scheduled Social Security Tax Increases with the Tax Changes Enacted During the Reagan Administration

($ billions)

	Fiscal Years									
	1981	1982	1983	1984	1985	1986	1987	1988	1989	Total 1981-1989
Tax increases since 1980 resulting from:										
Bracket creep due to inflation 1/	5.6	25.1	38.5	47.4	60.4	79.0	102.5	130.4	160.9	649.8
Scheduled social security increases 2/	9.8	17.0	19.3	20.9	31.2	39.1	45.8	50.2	54.2	287.5
Total, increases	15.4	42.1	57.8	68.3	91.6	118.1	148.3	180.6	215.1	937.3
Tax changes enacted during the Reagan Administration:										
ERTA (1981)	-0.3	-40.2	-91.1	-133.6	-165.0	-207.7	-248.5	-282.7	-319.2	-1488.4
TEFRA (1982) 3/	--	*	16.5	32.8	37.3	46.8	58.0	59.6	59.6	310.6
Surface Transportation Act (1982) 4/	--	--	1.5	4.1	4.2	4.4	4.5	4.6	4.7	28.0
Social security amendments (1983)	--	--	--	6.2	8.8	9.3	11.4	23.4	31.1	90.2
Other 3/5/	--	--	--	0.2	0.8	1.5	2.1	2.2	2.3	9.1
Total, enacted changes	-0.3	-40.2	-73.0	-90.3	-113.8	-145.7	-172.6	-192.9	-221.6	-1050.5
Net tax change from 1980 Law	15.0	1.9	-15.2	-22.0	-22.2	-27.7	-24.3	-12.3	-6.4	-113.2

Office of the Secretary of the Treasury
Office of Tax Analysis

February 1, 1984

Note: Details may not add to totals due to rounding.
*Less than $50 million.

1/ Amounts shown are the increases in individual income tax receipts (that would have been realized prior to the changes enacted during the Reagan Administration) resulting from inflation induced increases in effective tax rates since 1980.
2/ Effective rate increases from the structure in effect in 1980 (includes changes in the statutory rates in 1981-1989 and the ad hoc increase in the wage base for 1981 enacted in the 1977 social security amendments).
3/ Withholding on interest and dividends is excluded from the revenue effects of TEFRA: revenue effects of backup withholding ($1.1 billion in 1988) are included in "other".
4/ Amounts shown are the effect of the Surface Transportation Act on current services receipts, i.e., the effect of the Act extended beyond the expiration date compared to prior law extended beyond the expiration date.
5/ Railroad Retirement Revenue Act of 1983 and backup withholding only.

TAX INCREASES IN EFFECT

However, the TEFRA Act of 1982, which raised taxes, brings back a little over $37 billion; the Surface Transportation Act, the Nickel-a-Gallon Tax on Gasoline, brings back a little over $4 billion; Social Security amendments of 1983 bring back almost $9 billion, so the total among all of those tax cuts and tax increases is about $114 billion.

From that reduction, you will have to take what bracket creep since 1980 has done. Bracket creep alone, for fiscal year 1985, will add to revenues a little over $60 billion. Scheduled Social Security increases, which were scheduled back in the 1977 Act, bring in another $31 billion, that is a total of almost $92 billion.

If you add up all of these, subtract the others, you get a net reduction in fiscal 1985 of only $22 billion in revenues.

SOURCE OF ADDITIONAL SPENDING REDUCTIONS

Chairman HATFIELD. Mr. Secretary, I would be happy to receive those statistics for the record. Let me go back to my question and raise another one.

In your testimony, you refer to spending increases. All right, I have heard you speak many times that the deficit should be addressed by further spending reductions.

Let me ask you, where are the spending reductions that you would recommend?

Secretary REGAN. Well, we have started off in this budget with some suggestions in many areas. I believe it is described in part 3 of the budget document, but here is a summary. We are suggesting about $40 billion in non-defense spending changes during the 1985–87 period, and in the defense area, we have made some suggestions along the line of about $32 billion from our base.

Chairman HATFIELD. From your original baseline?

Secretary REGAN. That is right. So that is a total of $72 billion that we are suggesting here.

SPENDING INCREASES

Chairman HATFIELD. Mr. Stockman, would you like to comment on this question that goes to spending reductions and spending increases in relation to the deficit?

Will you identify the spending increases?

Mr. STOCKMAN. Mr. Chairman, let me respond in this way. You accurately quoted from the budget submission and what I have said. In constant dollars, domestic spending was about $528 billion in 1982 when we started this whole process. In 1984, after congressional action, there was $523 billion. So we can say that after 3 years of working on this budget, at least in constant dollars, it is slightly smaller on the domestic side than it was when we started. Our budget for 1985 and the out-years would keep it right at that level of about $525—$528 billion.

Chairman HATFIELD. But interest in defense of interest?

Mr. STOCKMAN. This does not include defense. This does not include debt service. That is only an observation of what has happened in the last 3 years. I feel compelled to make a second observation, which is also in the budget but which you didn't cite, and that is from 1970 to 1981 the domestic budget doubled in real terms. So when you ask where was the spending growth, most of it occurred during the 1970s.

CONSTANT DOLLAR SPENDING

In fact, during the 1970s, constant dollar spending for domestic purposes grew from $270 billion to $528 billion, almost double in 10 years. We have succeeded in stopping the growth and, therefore, that is an enormous step forward relative to the pattern of the 1970s. But we have not reduced it enough to bring the budget into balance.

INCREASES IN DEBT SERVICE AND DEFENSE

Chairman HATFIELD. In that same period of time, what have been the increases in debt service and defense (1981 to 1984).

Mr. STOCKMAN. Over that period defense had increased about 35 percent, 30 percent, and 35 percent in real terms.

Chairman HATFIELD. In constant dollars?

Mr. STOCKMAN. Yes, debt service has doubled in real terms.

Mr. FELDSTEIN. It is less than that.

Mr. STOCKMAN. Well, from 1980 to 1984, debt service has gone from about $55 billion to $100 billion.

Chairman HATFIELD. Mr. Stockman, I would just like to get these to apples and apples and oranges and oranges.

On page 3, you indicate that the 11 appropriations bills, excluding defense and military construction, the fiscal year 1985 request for discretionary spending authority is an increase of $1 billion from the 1984 enacted level.

Mr. STOCKMAN. Yes.

Chairman HATFIELD. Let me ask you this. If you took out of those $11 billion defense spending in the Department of Energy and military spending in foreign aid of the foreign assistance bill, what would that figure be?

Mr. STOCKMAN. As you noted, section A of my prepared testimony compares the non-defense appropriation request for fiscal year 1985 to the fiscal year 1984 enacted level. The $1 billion increase from 1984 to 1985 for total discretionary spending authority includes credit, administrative and obligation limitations. However, focusing only on new budget authority, for purposes of comparability, and excluding atomic energy defense activities in the energy/water bill and both military assistance and foreign military sales credit in the foreign assistance bill, the difference under your definition of non-defense spending is a $1.4 billion increase over the 1984 enacted level.

Chairman HATFIELD. It would be $1.1 billion less?

Mr. STOCKMAN. No; it would be $1.4 billion higher.

Chairman HATFIELD. Not more. It's as if you take all the apples out, put them in one place and all the oranges out and put them into another place.

Mr. STOCKMAN. I was just trying to accommodate the Appropriations Committee. Since you deal with the DOE Weapons Program within the Energy and Water Bill, I have included it in the Energy and Water Bill.

Chairman HATFIELD. But you should not have headed your page by saying, (*a*) non-defense appropriations requests for fiscal year 1985, because you include defense appropriations in two of those other bills.

Mr. STOCKMAN. I think it would be very desirable to take defense appropriations out of the Energy and Water bill and put them in the DOD bill. Then we would have the Energy and Water bill that is basically rivers and harbors and various other projects.

Chairman HATFIELD. Thank you.

[Laughter]

Chairman HATFIELD. Thank you.

As long as I am Chairman of that subcommittee, I think we will keep it there.

[Laughter]

Mr. STOCKMAN. Then I will keep this as non-defense appropriations programs, if you don't mind.

Chairman HATFIELD. Let's keep our titles straight on this.

LINE ITEM VETO AUTHORITY

Mr. Secretary, one last question I have, the President has asked Congress to give him authority for line item veto, and you have made remarks about this publicly and otherwise about how this would help to bring about some kind of narrowing of the deficit. If you look at the fiscal year 1985 budget proposals in this budget, may I just say for the record that it projects $156.7 billion in interest. This exceeds the budget authority for Agriculture, Commerce, Education, Energy, HUD, Interior, Justice, Labor, State, Transportation, EPA, NASA, GSA, SBA, the Legislative branch, the Judiciary branch, and the Executive Office of the President combined. Do you really believe that a line item veto will even make a dent in the current deficit?

Secretary REGAN. Well, certainly. But I think, of course, less appropriations and less of a deficit in the outyears is the answer to interest on the debt. But I do think that there have been many times in the past—and I think you are probably more aware of this than I—that things get tacked on. I notice in my own area, whenever we get a debt ceiling, there is always the threat that it will become a kite with a long tail, things of that nature where I think a veto will be appropriate to knock off those items. That is why I am for the line item veto.

PROJECTS SUBJECT TO LINE ITEM VETO

Chairman HATFIELD. What projects in your area would be subject to the line item veto?

Secretary REGAN. The entire Department would be subject—with the exception of the debt to the line item veto.

Chairman HATFIELD. Including the IRS?

Secretary REGAN. Certainly, if the appropriation for that were not what the President thought was a desirable rate. Anything would be subject to it.

Chairman HATFIELD. Would you recommend it?

Secretary REGAN. Well, that is pretty hypothetical. It depends upon what the Congress is giving me compared to what my request is.

Chairman HATFIELD. My time is up.

I would like to go into it as it might relate to an example here between the IMF and the housing proposal that we have passed in the last session of Congress, but I will talk to you later.

Secretary REGAN. That's a good one.

[Laughter.]

Chairman HATFIELD. Senator Stennis?

Senator STENNIS. Mr. Chairman, may I just use 1 minute of my time? There is a situation on the floor where they need the help of the Senator from Arizona, Mr. DeConcini. I ask unanimous consent that he be recognized on my time and out of order for the purpose of asking one question.

Chairman HATFIELD. I would be happy to.

Senator DECONCINI. Mr. Chairman, thank you, and Senator Stennis. I have to go to the floor to manage the bill on the minority side on the death penalty. I have a number of questions which I will submit to the various witnesses. I do have one for the Secretary, if you will indulge me, Mr. Secretary.

MORTGAGE-BACKED BUILDER BONDS

In light of the momentum that has occurred in the housing industry and through the innovation of mortgage-backed builder bonds that have been raising capital for that industry, the consumer has benefitted; the industry, as we know, is coming back from the worst time that it has had in its history, and instead of publicly working to continue this initiative and a willingness to pursue nongovernmental solutions to the industry's dilemma, I am told—and I hope I'm wrong—that tax officials within the Department of the Treasury are considering both administrative and legislative means for taxing the investment capital generated through these mortgage-backed builder bonds.

Now, can you answer us? Is that true? Is that the direction you are moving in, and if so, why?

Secretary REGAN. With regard to IDB's, what we are suggesting in this budget among so-called loophole closings is that a cap be put on the amount of IDB's that are issued for private businesses by States. That cap would be $150 per person in the State per year.

Senator DECONCINI. That would include builder bonds?

Secretary REGAN. Pardon?

Senator DECONCINI. That would include a cap on the builder bonds in a State?

Secretary REGAN. No, it would not.

Senator DECONCINI. Is that proposed in the budget?

Secretary REGAN. The IDB volume cap is proposed. That is one of the proposals that we have made here. As yet, it hasn't been put into a legislative proposal, but it is in the budget.

EFFECT ON HOME BUILDING INDUSTRY

Senator DECONCINI. Is it your opinion that that will not hamper the growth of the homebuilding industry?

Secretary REGAN. I will provide information for the record on our views with respect to builder bonds.

[The information follows:]

BUILDER BONDS

We are concerned about the use of builders' bonds because they involve significant tax deferral to homebuilders and taxpayers in other industries through the use of installment reporting while providing them with substantially all of the cash value of the installment obligations to collateralize the bonds. However, we are sensitive to the argument made by homebuilders that builders' bonds result in lower interest rates to homebuyers and are continuing to study the matter.

STIMULATION OF HOME BUILDING INDUSTRY

On the subject I mentioned above, the IDB's, while there still will be bonds of that nature allowed, not as many would be forthcoming, because by the time this budget goes into effect, we will be in the third year of recovery of the economy, hopefully, with lower rates of interest, at least that is our projection, and that combination by itself should be enough to stimulate the private sector in homebuilding.

Senator DECONCINI. You don't feel this is penalizing the homebuilders who have come up with this innovation and put themselves back on track with little or no Government subsidy?

Secretary REGAN. Again, I'll get back to you on the builder bonds. On the MSB's, the difference in interest rates is about 2 percentage points and we think that probably most of that can be made up in the private market.

Senator DECONCINI. So you favor taxes over the limit? You would tax that capital that is generated by those builder bonds over the cap?

Secretary REGAN. We still seem to be discussing two separate issues. On the private purpose tax exempt IDB's we would tax those who hold the bonds, the interest on those bonds, yes.

Senator DECONCINI. Thank you.

Secretary REGAN. Those, for the most part, would be wealthy individuals and the like who would be the holders of the bonds. There would still be a reduction; the interest paid would be a deduction for the tax.

Senator DECONCINI. The interest is generated by the builders after the tax is concluded. Then you would tax the builders above that, is that right, above the cap?

Secretary REGAN. Again, with respect to IDB's above the cap, these bonds would be taxable. With builder bonds and any interest paid by builders, their cost of money would still be a deduction to them.

Senator DECONCINI. That wasn't my question. I just wanted to note that, Mr. Chairman.

Thank you.

DANGERS OF HIGH DEFICITS

Senator STENNIS. Mr. Chairman, I am going to use a bad word here. I don't want to frighten anybody; I'm sure it won't frighten me, but Mr. Feldstein, there is talk about a possible collapse of the economy if no strong action is taken to head it off. Now, that is our business and that is strong talk.

A man asked me the other day to help me write his will. I told him, "Well, let's wait a few days."

[Laughter.]

Senator STENNIS. No, I say that in jest, but what harm do you see now in——

[Laughter.]

Senator STENNIS. What harm do you see in continually running this thing up around $200 billion a year, I mean, the deficit?

DOWNPAYMENT PROPOSAL

Mr. FELDSTEIN. I wouldn't use the word collapse. There is clearly a risk. There is harm if something isn't done. If the downpayment isn't made this year and there isn't a followup in 1985, then I think it's clear that interest rates will remain high or rise. It's clear that every year we wait as the debt accumulates, there is more and more interest to pay and an ever growing national debt, and that in the future means either higher taxes or bigger cuts in spending just to pay those extra interest costs.

This kind of $200 billion-sized budget deficit means crowding out investment in plant and equipment and housing, which means a smaller GNP in the future. In fact, if we don't have progress now in bringing down these deficits and more progress in 1985, then I think we won't have the kind of growth or resulting lower interest rates and that we will ultimately end up with even larger budget deficits and a bigger problem. So I think it is very important for us to get started soon.

Senator STENNIS. Well, I thank you.

RECESSION-PRONE ECONOMY A POSSIBILITY

Mr. Regan, I remember you quite well. I hadn't known you, but you came here so honest and sincere and still are, still are that way, but you ran into more than you realized then, and you have worked hard, I know. May I direct that same question to you, now? I am not predicting any collapse, but how do you look on that word?

Secretary REGAN. I would agree with Dr. Feldstein. I don't see a collapse coming, but I do see, if we don't have proper fiscal and monetary policies, the possibility of our slipping back into a recession again.

Senator STENNIS. A possibility of what? Excuse me?

Secretary REGAN. Slipping back into a recession if we don't have proper fiscal and monetary policies. By that I mean, if the deficits get too large—and they're treated in either of two ways, either with too much money or too little money—from the point of view of the Federal Reserve, both of these could cause higher rates of interest, or rather one of them could cause higher rates of interest, and the result would be a slowdown in business and a slipping back into recession, but not a collapse.

ECONOMIC DUNKIRK METAPHOR

Senator STENNIS. Along the same line, Mr. Stockman, I suppose my time is about up. If I remember correctly, and I used to remember a whole lot of quotes, Economic Dunkirk, I believe, was the word you used in talking about if something wasn't done to head off the possible collapse. You didn't use the word collapse, but that we would run into a situation that you called an Economic Dunkirk. In that field of thought, what is your response to my question here about this collapse, possible collapse?

EFFECT OF BUDGET DEFICIT ON ECONOMY

Mr. STOCKMAN. Senator, I don't have anything more to add that hasn't already been said. I think it's pretty clear to everybody here as to the diagnosis. Our problem is how to find some cure, how to put a package together that would solve the problem. I guess I would only note, since you have recalled the Dunkirk metaphor and since you probably have a keener sense of history here than anyone else, that despite Dunkirk, the British won the war, so I hope that in your talk of collapse we do not get overly pessimistic about what we can do if we put our minds to it.

Senator STENNIS. Well, I want to make it clear that I am not predicting a collapse either, but I have a natural sense of fear that unless something is done before the passage of too many years, it is going to, as is known now, there will be a collapse of some kind. That's why I am holding off about helping write that will.

[Laughter.]

Senator STENNIS. If I have no more time, I yield it back to you.

Chairman HATFIELD. Thank you, Senator Stennis. Would you yield to me for about 5 seconds?

Senator STENNIS. Oh, yes.

PREDICTIONS ON INTEREST RATES

Chairman HATFIELD. We are not making those predictions, Mr. Stockman, and yet you are making predictions. I believe that after 4 or 5 years, a deficit of $8 billion, you are predicting 5 percent interest rates?

Mr. STOCKMAN. I don't believe that we are predicting that. I have tried to make clear that——

Chairman HATFIELD. It is in the budget as a projection.

Mr. STOCKMAN. We have tried to make clear that that is the path that we would like to see the economy follow over the remainder of this decade. If it is to stay on that path, much larger changes in terms of budget reduction will have to be made next year and in succeeding years. In other words, we can make the 1984 economic assumptions, maybe even the 1985, with what we have got the coming year. But for the outyears, I assume the Congress will still be in business next year and the year after, as will the administration, we are going to have to do a lot more to stay on that economic path—including the 5 percent bill rate in 1989.

Mr. FELDSTEIN. I would just reiterate what I said in my opening remarks: that these are conditional; these are forecasts of what can happen with the kind of fiscal and monetary policies that we believe are necessary.

Chairman HATFIELD. An economy is based on growth and you are saying it is possible to have a smaller GNP.

Mr. FELDSTEIN. If we don't take those actions, as Mr. Stockman said, we are not going to see interest rates coming down to 5 percent, and we are not going to see or aren't likely to see this kind of solid growth over the next 5 years.

Chairman HATFIELD. The Senator from Connecticut.

Senator WEICKER. Thank you, Mr. Chairman.

LOW INCOME HOME ENERGY ASSISTANCE PROGRAM

Let me take care of one piece of old business. Mr. Stockman, last fall, I agreed to drop my amendment adding $193 million for the Low Income Home Energy Assistance Program with your assurance that should States need additional resources, funding would be accelerated and OMB would ask for a supplemental. I understand that a number of actions have been taken in order to provide funds to States that are running out of money currently. Will you elaborate on what actions have been taken to date with respect to the supplemental?

Mr. STOCKMAN. Mr. Chairman, we did indicate clearly at the time that if the Exxon case did not move forward rapidly there would be a need to come back for a supplemental. Yesterday, I approved a supplemental, which consists of $193 million plus $7 million interest, for a total of $200 million. It will be transmitted to your committee and to the House tomorrow.

Senator WEICKER. Thank you very much.

NATIONAL INTEREST PROGRAMS

Now let's get on to some of the comments that were made and a couple of phrases used in the budget. In section 3 of the budget—and I suppose I would address this to Mr. Stockman—the budget includes a new category of programs labeled "National Interest Programs," and these include Foreign Aid, Military Aid; Contributions to International Organizations; the Kissinger Commission funding; Department of

Energy Weapons Program; USIA; in addition to the NASA space program.

Why should these programs have higher claims on Federal resources than other domestic spending programs: education, biomedical research, maternal child health, housing assistance, et cetera? I don't understand this new category of national interest programs.

Mr. STOCKMAN. Well, Senator, let me respond by saying that there are 1,000 different ways to classify and organize the budget. We have done it this way because there is a set of programs that we believe ought to increase, not decrease, as would be our general position on most Government spending. Because we believe that these programs need to be increased in order to support important national objectives, whether it is foreign policy in the Middle East or whether it's our efforts at leadership in space and technology as we have seen dramatized in the last day or two, we have lumped all those together.

We call them national interest programs because the national interest is so great in these areas that it overrides the general requirement for constraint on spending and reduction that would otherwise be there.

I would also point out that priorities change from time to time and that in the 1970's almost all of these programs were shrinking drastically in real terms, whereas in the 1970's many of the programs that you have mentioned, and that are in your subcommittee jurisdiction, increased two-, three-, four-fold in real terms. So what we are proposing, let's say, for 1985 for the national interest programs is not unreasonable compared to what we spent in 1970. What we are proposing for your subcommittee is much greater both in real terms, the people that it will serve, and the need for it, than what we spent in 1970. So if we have some perspective on it, I think it is not unreasonable to say that these programs ought to rise slightly and that they can be grouped in the manner that we have.

STOCK MARKET FLUCTUATIONS

Senator WEICKER. To Secretary Regan and Mr. Feldstein, what do you think the market is telling us right now with the action of the past 15 days?

Secretary REGAN. Which market, Senator?

Senator WEICKER. Stock market.

Secretary REGAN. I think the stock market, having had a very sharp rise, is probably going to have some type of correction regardless of what happens. That would be a normal pattern in a bull market, characteristic of all prior bull markets, in which the first leg is up, there is a correction, and then the second leg.

The correction seems to have come about over the last 5 or 6 weeks, based, primarily, on fears of high interest rates, current and future.

With the stock/bond yield probably at one of its widest points of disparity in years in favor of bonds rather than stock, a money manager faced with that type of situation naturally tends to think in terms of locking up some of these 12 and 13 percent interest rates that are

achievable in the bond market, rather than taking the vicissitudes of the stock market, particularly after it has risen so far and so fast.

Along with high interest rates, obviously, come the fear of deficits and what effects deficits will have on high rates of interest in the future. That combination, plus, of course, what is happening in the Middle East is very unsettling as far as world-wide investors are concerned. Put all of those three things together, and I think it is rather obvious what has happened to the market.

Senator WEICKER. Mr. Feldstein?

Mr. FELDSTEIN. I don't want to exaggerate my ability to explain short-term shifts in the stock market. I don't think anybody can be very confident about what makes the market go up or down 5 or 6 percent, but I would agree with the things that the Secretary mentioned and I would emphasize the fact that real interest rates are likely to come down unless the deficit is reduced.

The fact that budget deficits loom as large as they do, I think, continues to suggest that these high yields on bonds are likely to continue in the future, and given the choice between earning real rates of 5 or 6 percent on very high quality bonds and taking the risk associated with stocks, some are moving money from one to the other.

RECESSION POSSIBILITIES

Senator WEICKER. Assuming the fact that the Congress and the executive do not agree on a program of deficit reduction of a substantial nature, when would you foresee that we could be moving back into recession?

Mr. FELDSTEIN. Well, let me say two things: First, about the size and then about the possibility of foreseeing recession.

I think that if we do have success in these negotiations, that if there is a modest downpayment now of $100 billion over 3 years—and it is very clear to financial investors and to the business community that that is just a downpayment that if it is the will of the Congress and the administration to come back in 1985 and do more, then I think we are on the road to the kind of solid economics that I talked about in our outlook.

If that doesn't happen, then it is clear we increase the risks of trouble for the economy. But I don't think anybody can forecast just when a downturn is going to occur except when the economy is pretty close to the peak.

The leading indicators are pointing up; business and consumer confidence is high, so there is no reason to expect a downturn in the near future. And to try to put a date on it, next year or the year after, I think, is too hard at this point, too problematic, and too hypothetical until we see what really occurs in these negotiations.

FULL ASSAULT ON DEFICITS IN 1984

Senator WEICKER. You say, in your testimony, every year that we wait to address the deficit compounds the problem. Why should we be putting a downpayment on this problem? Why aren't we meeting it head on this year?

Mr. FELDSTEIN. Obviously, if we could do more, that would be fine. The budget that we sent up last year—and I think last year should have been easier than an election year—would have cut the budget deficit almost in half by 1988; that is, by 1.5 percent of GNP. As you know, there was no action.

In the House, there was an immediate rejection of the whole principle that underlay that budget.

ELEMENTS INVOLVED IN BUDGET REDUCTIONS

Senator WEICKER. Do you feel that any meaningful solution to the problem would have to entail the three elements: revenue raising, reduction in defense spending and the entitlement programs?

Would it have to include all three?

Mr. FELDSTEIN. As the Secretary indicated before, all three of those are in this year's budget, and we have said that at the negotiations everything is on the table.

Senator WEICKER. The budget calls for reductions in defense spending?

Mr. FELDSTEIN. Relative to the request that we had last year.

Senator WEICKER. Well, I am talking about in real dollars. This is not reduction.

Mr. FELDSTEIN. Those are real dollars. But let me say more generally, though, that the negotiations are open. We have started with the assumption that everything is negotiable; that everything can be put on the table and discussed.

That is all the things you mentioned.

Senator WEICKER. Including revenue raising, additional taxes?

Mr. FELDSTEIN. The budget calls for $33 billion in real money. People will pay additional taxes if those tax loopholes are closed.

ACHIEVEMENTS IN DEFICIT REDUCTIONS

Senator WEICKER. What do you think is achievable insofar as reducing the deficit for fiscal year 1985?

Mr. FELDSTEIN. I don't know how to answer that. I think we are just going to have to see how the negotiations proceed. I think the important thing is not what gets done in 1985, although obviously reducing that deficit is important. The important thing is the sense that the deficit will be coming down substantially over the decade and will be close to balance by the end of the decade.

Senator WEICKER. Let me repeat: Do you think the deficit could be reduced substantially in fiscal year 1985?

Mr. FELDSTEIN. That is not a question of economics; it is a question of my guess about what will happen in these negotiations. If they

produce $100 billion, how much of it will be in the first year? I don't think that one-third of the $100 billion cut in deficits will occur in the first year.

I think the package as a whole would be a meaningful downpayment to start progress and strengthen confidence.

DEFICIT REDUCTIONS IN FISCAL YEAR 1985

Senator WEICKER. What do you look for, Secretary Regan, in terms of deficit reduction in fiscal year 1985? What do you think is possible?

Secretary REGAN. I have to go with what Dr. Feldstein said. It depends on if we get 100 or more out of these negotiations between the Congress and the administration. Obviously, it will probably come up to something on the order of 20, 30, 50.

BLAIR HOUSE MEETING ON DEFICITS

Chairman HATFIELD. Before I invite the Senator from Kentucky to ask questions, it might help the rest of our panel here in this session if you would give us a very brief expression of how you assess the first meeting this morning at the Blair House on negotiating this deficit problem?

Did you take hope? Do you feel optimistic? Could you give us some kind of an assessment?

Secretary REGAN. I would say that I was encouraged by the meeting this morning at the Blair House. It lasted for about 1¾ hours. We put forth some ideas that we had for a deficit reduction. There were some that came from the other side. Both the majority leader of the House and Senator Inouye stated that they would be faithful reporters of what had happened to the people that they represented.

It is my understanding that there was a Democratic caucus to be held to which Senator Inouye would report. I would say that the meeting did produce the fact that the $100 billion could be achieved if we could agree on the items.

Obviously, there would be disagreement on some of the items. Those are pretty well known. But it was achievable. It is not an impossible task. The facts now remain as to whether we could get together in the near future for another meeting. We are hopeful that there will be another meeting, and if that occurs, I think there will be progress in moving the ball forward.

MARKET STABILITY

Senator HUDDLESTON. Thank you very much, Mr. Chairman.

Well, a good deal has already been said about the whole question of a budget carrying the size of a deficit that we are talking about now and the effect that it is going to have. I have noted in the press quotes from Chairman Paul Volcker, for instance, that there is a clear and present danger to the sustainability and growth of the stability of our markets.

Secretary Regan, you have said here again today as you have before

that there is a risk, a great deal of a risk if the deficits are not reduced. Mr. Feldstein has said again that the continued deficit will twist the economy out of shape. Mr. Volcker did add some urgency to his statement that if something isn't done with the policy that there is not much time to act. I don't see any urgency in this group here today, and I don't see any urgency in the document that has been submitted to the Congress. I don't see any explanation why a $60 billion deficit in 1980 was a horribly intolerable thing and a $180-something billion deficit 3 years later is acceptable and something that we will get around to doing something about when we can, not now, not in the original submission, but if we can get everybody to agree and get a bi-partisan group together, we will sit down at the Blair House, and maybe we might do something about this; we might make a downpayment on it, even, a very insignificant downpayment of $100 billion over a 3-year period.

What's happened. I mean, where is all this urgency that we used to have that doesn't seem to exist today?

Mr. FELDSTEIN. I think there is urgency. I think we definitely want action now.

Senator HUDDLESTON. Why haven't you included it in the budget, then?

Mr. FELDSTEIN. I think the risk of submitting a budget like last year's budget, which contained a lot of suggestions, which when enacted, would have done the job, runs the risk that nothing would have happened.

Senator HUDDLESTON. Did not Congress last year appropriate in the aggregate less money than you asked for?

Mr. FELDSTEIN. I don't know the answer to that.

Senator HUDDLESTON. Mr. Stockman, what do you say to that?

Mr. STOCKMAN. If you are including the debts and adding it all up, it would be——

Senator HUDDLESTON. The answer would be yes.

It is just kind of a strange thing to me. What you are really saying to us and what you are saying to the American people is that conventional wisdom is right, that neither the administration nor Congress is going to come to grips with difficult and unpopular decisions during an election year.

Mr. FELDSTEIN. Neither alone, but perhaps both together, can.

Senator HUDDLESTON. Pardon?

Mr. FELDSTEIN. Neither alone, but perhaps both together can.

BUDGET SUBMISSION FOR FISCAL YEAR 1985

Senator HUDDLESTON. But somebody has to submit the budget, and we have to begin from there. We are starting, it seems to me, from far behind. Did you have some comment?

Secretary REGAN. I would say that what we have submitted here is a base line budget recognizing reality and recognizing, as Dr. Feldstein has said, that last year when we submitted a proposal for deep cuts plus some contingency taxes, that budget was rejected out of hand. So this

year, we decided, well, we'll try a different strategy. We will send up a base line budget which we can live with, but we would rather see these deficits brought down, and recognizing the reality of this being a very contentious year because of political factors, of a year divided by——

Senator HUDDLESTON. Last year—excuse me—last year toward the end of the session when people from your party in the Senate, particularly, were working very hard to create a deficit reduction package, I wasn't in on that; I wasn't on the committee, but I don't recall them getting any kind of encouragement or assistance and finally, of course, it died on the vine.

Secretary REGAN. That was because—I could only speak to the revenue side. Obviously, that was my area, but on the revenue side, what they were suggesting were not things that we ought to do in the first year of recovery. They were making major tax increases of a sort that we thought would not be helpful to the economy, and therefore, we didn't go along with them.

INACTION ON BUDGET DEFICITS

Senator HUDDLESTON. It seems to me like we are in a catch-22 situation. If we do anything to do something about the deficits then we are going to adversely affect the economy. If we don't do something about the deficits, the economy may, to quote the distinguished Senator from Mississippi, may collapse. Now, what is it we are supposed to do?

Secretary REGAN. Go ahead.

Mr. FELDSTEIN. I think the crucial issue is timing. The strategy in the administration's budget submission last year was to ask for enactment then of major budget deficit reductions that would begin not immediately, but a couple of years out. The reason for that was to give the financial market notice that future deficits are going to be coming down. Then interest rates can decline and the dollar can become more competitive; then investment will pick up; exports will pick up. But that only happens with a lag. So the important thing is not to hit the economy hard suddenly with a deficit reduction but to do it with some preannouncement, with some precommitment.

Senator HUDDLESTON. And particularly if the lag goes at least beyond the general election.

Mr. FELDSTEIN. I would say that is true regardless of what year we started and whether or not there was an election.

AGRICULTURE BUDGET

Senator HUDDLESTON. Secretary Regan referred to the reality of this budget, and I think that is something we are all going to be confronted with. In reality, there are probably a good many assumptions that will not hold true. I am not totally critical, because we are talking about something that is not an exact science, but I am curious about the agriculture field, Mr. Stockman. I assume the figures you have there substantially reducing the cost of agriculture programs are predicated on your judgment that next year is not going to be the best year in the

history of agriculture in the United States from the standpoint of net income. It's going to be substantially above anything we have ever experienced before in this country.

It's going to be at least 30 percent above the previous record of agriculture income of $32 billion a year. You are predicting $42 billion a year, as I understand it, and that is not—I don't know how you came to that figure, and perhaps you can explain it to us, but I was wondering if you have ever seen this particular publication, which that happens to be the Agriculture Outlook by the Economic Research Service of the United States Department of Agriculture. They are supposed to be experts in the field and at least devote a portion of their time to agriculture matters.

Their estimates are substantially below yours, in the $35 to $37 billion range. Now, if there is not much difference in what actually happens, I assume it would affect those figures substantially, is that correct?

Mr. STOCKMAN. I am not quite sure which figures you are referring to, but if you are referring to what I have in my testimony today, that excludes the CCC, the Price Support Deficiency Payment Program, Farmers Home, and so forth. We don't charge that to the Appropriations Committee because it is in the jurisdiction of Agriculture.

The reason the rest of what I have shown here is basically not related directly to saving the agricultural economy is that the reduction in here is almost entirely for the REA. I can't find much evidence that the REA is related to the agricultural economy.

REDUCTIONS IN ALL AGRICULTURE ITEMS

Senator HUDDLESTON. I see reductions in every item across the board in the budget document that I have here.

Mr. STOCKMAN. The reductions elsewhere are quite modest. For the Extension Service it is modest. Agriculture subsidized lending is about $4 billion, what we had last year.

Senator HUDDLESTON. From $20 billion in outlays to $8.9 billion? That's modest?

Mr. STOCKMAN. If you are using the budget then you are counting the CCC. Well, that is automatically declined under current law. We are not even changing current law for the Farmers Price Support Program in 1985. That is just a natural reduction.

AGRICULTURE NET INCOME

Senator HUDDLESTON. My simple question was, how did you estimate that the net income is going to be so expensive next year?

Mr. STOCKMAN. I'm not sure what net income figures you are referring to. I don't have anything in the budget under the net income of the U.S. agriculture sector that I know of.

Senator HUDDLESTON. $42 billion is what I have.

Mr. FELDSTEIN. Senator, I don't know the source of that number. Let me just mention two figures, though, that make it seem to me that it may not be so unreasonable. Net farm income in 1981 was $30 billion.

Senator HUDDLESTON. 1981?

Mr. FELDSTEIN. Between 1981 and 1985, GNP as a whole will rise by more than a third. If net farm income can rise by the same proportion as the GNP as a whole does, it will be over $40 billion.

Senator HUDDLESTON. If that had been the case before, the farmer would be a very happy person, but while the GNP was rising his income—he went from a record figure, $32 billion, down to almost—to about half that.

Mr. FELDSTEIN. It was $23 billion in 1983. But if it's——

Senator HUDDLESTON. $42 billion is written right into this document. You are familiar with that one, aren't you?

Mr. STOCKMAN. Tell me what page it is and I can tell you how it was formulated.

Senator HUDDLESTON. It is on page 5–55. I will read it for you. It says, "The net farm cash income is expected to reach a record level of over $42 billion."

Mr. FELDSTEIN. Oh, cash income; net cash income in 1983 was $43 billion. Net cash income in 1983 was $43 billion.

Mr. STOCKMAN. Senator, you are dealing with different concepts between the figures you are reading from the Economic Research Service and the figures cited here.

Mr. FELDSTEIN. There is quite a difference between net farm income and net cash income. The net farm income in 1983, according to the Department of Agriculture, was $23 billion. The net cash income was $43 billion in 1983.

Senator HUDDLESTON. Then your statement is wrong, because you are going to go to $42; that is a billion dollars less and you are calling it a record.

Mr. FELDSTEIN. I still can't find it.

Senator HUDDLESTON. We are talking about the exact same figures.

Mr. STOCKMAN. All I know is that most of it came from the taxpayers.

Senator HUDDLESTON. Came from what?

Mr. STOCKMAN. The taxpayers.

Senator HUDDLESTON. Not most of it, about half of it.

Mr. STOCKMAN. That is a goodly share.

Chairman HATFIELD. At this point, someone has been saved by the light. I would ask the Senator from——

Senator HUDDLESTON. Is my time up?

Chairman HATFIELD. Yes. It has been up for a while.

Senator HUDDLESTON. Oh, it has? [Laughter.]

Chairman HATFIELD. Do you want to complete your point? Please do.

Senator HUDDLESTON. No.

Well, my point is that if you are making those kinds of estimates that don't seem realistic and the program that you are outlining is based on that, then the American farmer is going to be in for another very tough year, and I think we need some assurances that we are going to have a realistic approach to what the estimates would be of his income.

Chairman HATFIELD. The Senator from New York?
Senator D'AMATO. Thank you very much, Mr. Chairman.

FISCAL AND MONETARY POLICY

Mr. Chairman, I heard it said that we need an intelligent fiscal and monetary policy to put the budget in shape and reduce the huge deficits. What actually are we talking about? Mr. Stockman, if you didn't have a Congress to deal with and you were going to enact whatever program, fiscal, monetary or otherwise, what would you do? How are we going to balance the budget and Government spending?

Mr. STOCKMAN. Senator, that is a hypothetical question. If the Congress didn't exist, we wouldn't be dealing with a $180 billion problem in 1985.

Senator D'AMATO. That is ridiculous.

Mr. STOCKMAN. I am not going to try to answer——

[Laughter.]

Mr. STOCKMAN [continuing]. A hypothetical question based on a hypothetical situation.

ACID RAIN QUESTION

Senator D'AMATO. That's pretty good. That's pretty good. That's the usual ducking answer that you give us. You are trying to lay all the blame on domestic spending when the fact of the matter is that these programs have been cut to the bone. Not even you have proposed in the budget the kind of draconian, ridiculous cuts that you put in before that would have hurt working middle class families, and that would have really hurt the President. You consider yourself the political expert. My God, I just came back from a hearing in Albany, N.Y., on acid rain. I was surprised and taken back to find out that you have considered the acid rain problem in a paper called "The Politics of Acid Rain." Is that true? Did you do that?

Mr. STOCKMAN. I think I did.

Senator D'AMATO. "The Politics of Acid Rain." Incredible, incredible.

[Laughter.]

Senator D'AMATO. That is what your proposed budget is made of, politics. Then you wonder how we are going to reduce the deficit. You only think in terms of politics. Only Dr. Feldstein has proposed real action on the deficit, even though I am opposed to tax increases.

ENTITLEMENT PROGRAMS

You have to address the entitlement programs don't you? Are you afraid to say you can't deal with the entitlements, if you don't begin to reform the entitlements, you can't reduce Government spending?

PROPOSED REDUCTIONS IN ENTITLEMENTS

Mr. STOCKMAN. We have tried to address that. We tried to address school loans. You said that resulted in grave harm to middle income families. The other issue we tried to address was medicaid. You said that would do grave harm to the people in New York. The point is, we

have gone down the list and it doesn't do any good to explain these kinds of debating points. We know after 3 years what you might be willing to consider, and you know what we would like you to consider. It seems somehow——

Senator D'AMATO. I would like you to outline reduction proposals. Instead, you have offered only politics.

Mr. STOCKMAN. There are a lot of items in this budget that take about 50 pages and gives the precise details, nothing radical, nothing draconian, much of it from what we have learned from you and others over the last 3 years about what you believe is fair and appropriate. It seems to me we ought to at least do that.

FREEZE RECOMMENDATION

Senator D'AMATO. It seems to me there is one person in Congress, and I am not endorsing his candidacy because I am working for the President's reelection, who at least had the guts to come forward and propose a broad-based freeze. You and others said, oh, no, don't support the Hollings freeze. Again you were playing politics rather than trying to curb the growth in spending across the board.

I didn't see anybody at OMB support Hollings. I didn't see the Secretary of the Treasury saying, "Why don't we try and build a bipartisan coalition around the freeze proposal. Now we are talking about the politics of an election year." Why don't we be truthful to the American public and say, look, we are not going to come forward with anything unless both sides support a bipartisan compromise. My God, you would not specifically mention medicare or social security because you could get blown out of the water, and you know it. So say it, you are ducking the issue and playing politics.

INDUSTRIAL REVENUE BONDS

Industrial revenue bonds, there you go again. You believe that these restrictions will balance the budget. Your proposed budget tells me that you feel that IDB's are the root cause of the deficit.

What are we going to do?

Chairman HATFIELD. What is the question, Senator? [Laughter.]

Senator D'AMATO. The question is, how much revenue are you going to produce by putting your cap on revenue bonds, and do you back this up with a statistical study that IDB's cut the revenues on a net basis.

Secretary REGAN. I will submit the study for the record. Fifty-four percent, now, of all municipal bonds are used for private purposes. They are being used for some very curious purposes including boxes at sports arenas, things of that nature. What we are saying is that the administration's proposed restrictions on private purpose bonds, including the volume cap, will produce $1.4 billion in additional revenue over a 3-year period 1985, 1986, 1987, if they're capped at $150 per citizen of the States per year.

PROPOSALS FOR DEFICIT REDUCTION

Mr. STOCKMAN. Senator, if I may respond, I think there is one other point that needs to be made here in fairness. You are suggesting that there are some very big tough things that we ought to do that nobody is talking about or looking at and that, instead, we are picking on all these little nitpicking items. Anybody that believes that there are five things you can put together that will solve the whole deficit problem of $20 billion each is wrong. I will say right here, if we were to dare to freeze the COLA's on the unmentionable, that would save $4 billion a year. Now $4 billion versus $200 billion isn't much, and there isn't any other step that you could think of or anybody else on this committee could think of, whether it is in the Tax Code or on the spending side, that is going to amount to much more than a couple of billion dollars per year. That is why we have to assemble a lot of things from different parts of the budget even if some of them appear small relative to the total magnitude of the deficit or uncomfortable relative to what certain constituencies might like.

There is no one, big step that's available.

MONEY SUPPLY TARGETS

Senator D'AMATO. Mr. Volcker in his testimony before the Banking Committee today stated that the money supply targets for this year will remain roughly the same as the targets established in 1983; in fact, the money targets—M_1, M_2, and M_3—will be slightly reduced.

What effect is that going to have, Dr. Feldstein, on interest rates?

Mr. FELDSTEIN. I think that reducing them in that way is consistent with the kind of real growth and the capping of inflation that we have anticipated. I think interest rates are going to stay high. I think they are going to stay high because of the basic pressures that come from borrowing in these markets. If you see any decline in the dollar, and a reduction in the inflow of capital from abroad, those rates will go higher still.

IDB'S

Senator D'AMATO. If I might, Mr. Chairman, let me just make one observation concerning IDB's. Knock out the abuses such as liquor stores and sky boxes. But don't kill the program. Why try and balance the budget through IDB restrictions. Why not address the problem: the entitlement programs. There has not been a definitive study to show that IDB's cause a net revenue loss. Those studies that have been conducted have demonstrated that, especially during times of high interest rates, economic activity is encouraged through the use of IDB's.

But to date, we have just got this one attitude, the whipping boy attitude, that economic development must bear the burden of reducing the deficit.

You are going to continue to ignore the source of the deficit dilemma and, thus, there will be no consensus to form a broad-based cohesive policy that is necessary to deal with the problems of the deficit. I think we are missing the boat.

Thank you, Mr. Chairman.

Chairman HATFIELD. Thank you, Senator.

The Senator from Wisconsin, Mr. Proxmire.

Senator PROXMIRE. Are we doing this on the order of coming in, because I did come in after the Senator from Missouri and the Senator from Arkansas.

Chairman HATFIELD. Who came in first?

Senator PROXMIRE. The Senator from Arkansas.

INCREASE IN INTEREST PAYMENTS

Senator BUMPERS. Mr. Secretary, let me ask you—let me direct this question to Mr. Stockman, if I may. It seems to me that what we have here is we are trying to deal with the deficits, and I certainly have no objection of dealing with them in a bipartisan way. I will do my very best to cooperate in a bipartisan way as long as everything really is on the table. But when the President, for example, says one day, that everything is negotiable and the next day I see him on television in Atlanta saying the one thing they may not do is to raise your taxes, and then at other times he says defense spending is not negotiable, and when you consider the fact that social spending, as the Senator from New York has said, social spending has been cut to the core, let me digress a moment just to ask you if you saw the front page story in the New York Times Sunday that since the President became President through this very moment, through 1984, the increased amount of interest we are going to pay is $10 billion more than all the cuts.

Precisely, the figures are that for the 4-year period, CBO estimates that from 1982 through 1985 social welfare savings will be an accumulative total of $110 billion, and the increase in spending on interest payments alone is $124 billion. So interest during the cumulative 4-year term of this President will be $14 billion more than all the cuts.

It seems to me, to get back to where I was a moment ago, if we are not going to cut any more social programs, and I think you have said the same thing in Fortune Magazine, and I agree with you wholly, if we are not going to do that and defense is off limits and taxes is off limits, it seems to me that the bipartisan appeal is an appeal to say, you people get together over there and give these American people the bad news on entitlements, social security, and medicare and so on.

Do you acknowledge that is a fair statement?

CLOSING OF TAX LOOPHOLES

Mr. STOCKMAN. No, I don't think it's a fair interpretation of what we have been saying. I think there is a lack of precision in the interpretation that you have given that is important. I think what the President said was that he would not accept a large, across-the-board increase in taxes indiscriminately. However, what the budget shows is that closing tax loopholes in the structure is something we are advocating, some $75 billion worth over the next 5 years. What the state of the Union message said when the downpayment negotiations invitation was offered

was that we are more than happy to look in the area of tax code reform and loophole closing as part of the package that would include revenue raising.

Further, I think it has been made very clear that we believe we need every dollar of the $305 billion in defense but that we are willing to talk about congressional proposals that might adjust that somewhat. We have for the last 3 years—I have demonstrated it here—ended up with slightly less but most of what we requested. We expect that kind of process of debate and adjustment will occur again this year.

So to conclude with some kind of unequivocable statement which has been made, defense is off limits, revenue is off limits, that we are talking about putting the entire requirement on entitlement spending is totally inaccurate. That is what we are talking about.

SPECIFIC AREAS OF BUDGET CUTS

Senator BUMPERS. I still have not heard an answer to Senator D'Amato's question. Where should the cuts be made, specifically? Should it be in maternal and child health, women, infants, and children, immunization programs, student loans? Tell me precisely.

Mr. STOCKMAN. Let me give you a starting list that I believe we could do that.

Last year, we delayed the COLA's for social security for 6 months. Everyone around here agreed that if it was fair for social security, it would be fair for military, civilian retirees and veterans. We haven't done that yet. If we don't get to it and get it done we are going to end up with the social security recipients taking a 7-month, 6-month delay but nobody else. That is one thing we should do.

Senator BUMPERS. I am inclined to agree. How much will that save?

Mr. STOCKMAN. That will save $3 or $4 billion over the next year and more if it is continued long run. Second, we recommended last year that the farm price supports be frozen, not reduced, not be taken away, but the automatic escalation be stopped the last year. I have indicated this to members of the Agriculture Committee that would be willing to make adjustments in return. They don't like our 1984 program for commodities to make adjustments in return for freezing prices. That seems to me a solid thing to do.

Nobody is going to make any sweeping changes in medicare benefits or eligibility. But we have recommended some cost saving measures like freezing physician fees and changing the reimbursement for clinical laboratory reimbursement. Those were in House and Senate bills last year approved by both committees.

Senator BUMPERS. Do you think all the savings will come at the expense of the providers, is that right?

Mr. STOCKMAN. I am saying for right now, that is all we can do. That is all we can agree on.

Senator BUMPERS. How much will that save?

Mr. STOCKMAN. I think on a 3-year basis we could find $3.6 billion entirely off the providers' side just for the patients.

Chairman HATFIELD. Could we have a list of these in detail for the record?

Mr. STOCKMAN. Yes.

[The information follows:]

Excerpt From Senate Budget Committee Testimony

My prepared testimony before the Senate Budget Committee on February 2 included a section on possible areas for future structural reform. This portion of my testimony, which I am providing for the record, addresses eight specific budget categories:

III. EIGHT POSSIBLE AREAS FOR FUTURE STRUCTURAL REFORM AND MAJOR BUDGET SAVINGS

While major strides in budget control have been achieved over the past three years, it should not be concluded that all savings possibilities have been exhausted. Some programs such as agricultural price supports and student aid have escaped the general regime of fiscal restraint since 1981 and must now be firmly curtailed. Consideration of other major reform candidates -- such as military and civilian retirement -- has been deferred, but these programs must be subjected to fundamental scrutiny and revision next year. Finally, the Grace Commission report contains literally hundreds of suggestions in the areas of federal overhead reduction, procurement reform, and unjustified economic subsidies which, after further analysis and refinement, can be expected to generate substantial savings proposals for next year's budget.

In particular, the following eight budget categories illustrate the opportunities for significant future savings beyond the limited measures proposed in the 1985 budget. In most cases, the detailed analysis necessary to estimate savings and justify proposed policy changes is still underway -- with much work yet to be done. Nevertheless, they illustrate both the major

opportunities as well as the kind of hard choices which will face the Administration and Congress next year in what must be a full-throttle effort to close the budget gap, if economic recovery is to be sustained.

1) Farm Price Supports

As is shown below, the 1981 farm bill will result in the highest constant dollar net outlays of any 5-year period in recent history. Fortunately, this counter-productive law expires beginning with the 1986 crop year. This presents an opportunity for major savings beginning in FY 1987 if a more market-oriented price support and subsidy program can be fashioned next year. The current wide gap between out-of-pocket production costs and price support and target levels must be substantially closed if costly surpluses and major commodity market imbalances are to be avoided in the second half of the decade:

POTENTIAL FOR FARM PRICE SUPPORT AND SUBSIDY SAVINGS:
CONSTANT DOLLAR COSTS OF 1981 FARM BILL
COMPARED TO PRIOR PERIODS
(billions of constant 1985 $)

	Average Annual Constant Dollar Outlays	% of 1981 Farm Bill (1982-86)
1962-1966	9.4	76%
1967-1971	10.0	81%
1972-1976	4.9	40%
1977-1981	6.1	50%
1962-1981 Average ...	7.6	62%
1981 Farm Bill, 1982-86	12.3	100%

2) Student Aid and Higher Education

Between 1970 and 1978, constant dollar federal support for student aid and higher education increased from $3.6 billion to $5.5 billion or about 53%. This substantial rise in real spending levels was generally consistent with the 80% constant dollar increase in overall domestic spending, excluding social insurance and low-income entitlements, which occured during this same period.

Since 1978, however, constant dollar spending for non-entitlement domestic spending has declined markedly as shown in the table below. By contrast, 1984 enacted student aid and higher education constant dollar outlays will be 46% higher than 1978 and only slightly below peak levels reached in 1981 ($8.3 billion). Thus, this category of the budget has escaped the general retrenchment of non-entitlement spending almost entirely. Since federal support of nearly 50% of all students enrolled in instutitions of higher education is more than the Nation can afford, a substantial funding rollback will be an unavoidable imperative on the structural reform agenda for future budgets:

CONSTANT DOLLAR STUDENT AID AND HIGHER EDUCATION FUNDING TRENDS VS OTHER DOMESTIC SPENDING
(billions of constant 1985 $)

Year	Domestic Spending Excluding Social Insurance and Low-Income Benefits*	Student Aid and Higher Education
1970	115.4	3.6
1978	207.7	5.5
% Change from 1970.	+80%	+53%
1984 Enacted	158.4	8.1
% Change from 1978.	-24%	+46%

* As detailed in Part III, FY 1985 Budget.

3) Veterans Health Care System Efficiencies and Improvements

The operating and construction costs of the nation's veterans health care system nearly doubled in real terms between 1970 and 1980. Moreover, unlike most other categories of discretionary spending, constant dollar costs have continued to rise -- with the 1984 enacted budget up a further 8% in real terms from the 1980 level. Under the 1985 budget proposals, projected future costs continue to increase in real terms, rising by 30% between 1980 and 1989.

This rising cost trend represents both increases in medical care costs generally and the increasing pressures brought on the existing, inadequate VA system by a rising number of eligible veterans. Within the framework of current eligibility criteria, delivery system organization and hospital capacity, it is extremely doubtful that this continued rise in real budget costs can be avoided. However, the Grace Commission findings, as well as those by many medical economists, suggest that the nation's health care commitments to its veterans can be met at substantially less cost over the longer run if the current policy framework is adjusted. Such structural reform options include greater internal economic incentives, wider use of excess facilities in the private health care system, tighter implementation of the "inability to defray" standard, firmer service-connected disability requirements, and cost-sharing and third party cost recovery mechanisms. The Administration will be studying these options intensively within the coming years, with a view to finding ways to meet existing veterans health care commitments at significantly lower costs in the years ahead:

CONSTANT DOLLAR TREND IN VA HEALTH CARE SYSTEM

(billions of constant 1985 $)

Year	Constant Dollar Budget
1970	4.7
1980	8.7
Percent Change from 1970	85%
1984 enacted	9.4
1987 proposed	10.6
1989 proposed	11.3
Percent Change from 1980:	
1984	+8%
1987	+21%
1989	+30%

4) Medical Entitlements

The rapid, sustained constant dollar growth of the medicare and medicaid programs are nearly unprecedented in federal budget history. Between 1968 and 1981, the constant dollar cost of these entitlements rose from $17.8 billion to $65.8 billion -- or at a compound annual rate of 10.4%. Despite a variety of cost-saving reforms adopted since 1981, 1984 constant dollar spending will be up another $17 billion reflecting a 7.9% rate of annual increase. By contrast, overall domestic spending has actually declined in real terms during the same period.

Moreover, even assuming the tight reimbursement restraints embodied in the prospective payment system for medicare (DRG) and similar state level medicaid reforms, constant dollar current services costs are projected to rise another $36 billion by 1989 -- representing a 7.5% rate of annual real increase from the 1984 level.

These trends make clear that much more must be done to restrain the cost growth of the federal medical entitlements. Without such additional efforts there is virtually no prospect of maintaining medicare solvency in the 1990s, nor of meeting the rising needs of the low-income elderly and families assisted by medicaid.

Since the underlying source of this enormous, sustained cost growth lies in the structural inadequacies and inefficiencies of the U.S. health care system and the lack of economic incentives for providers and beneficiaries alike, only generic reforms of a fundamental and far-reaching nature offer the potential for significant long-term cost reduction. Such generic reforms in the areas of reimbursement, health care delivery system organization, provider risk absorbtion and beneficiary cost-sharing are therefore essential items for future consideration.

CONSTANT DOLLAR TREND FOR MEDICARE/MEDICAID
(billions of constant 1985 $)

Year	Constant Dollar Budget Level
o 1968	17.8
o 1981	65.8
o Annual real growth from 1968	10.4%
o 1984 enacted	82.7
o Annual real growth from 1981	7.9%
o 1989 current services .	118.8
o Annual real growth from 1984	7.5%

5) Federal Military and Civilian Retirement Pensions

Federal civilian and military retirement pensions have historically been more generous than their private sector counterparts for reasons that have now been largely surpassed by events and policy changes over recent years. It was argued that low military pay levels prior to 1974 justified large pensions and generous early retirement privileges as a form of "deferred compensation." Likewise, until the 1983 Social Security Act, federal civilian pensions served the dual prupose of providing both a basic social insurance equivalent as well as a private pension supplement.

Nevertheless, even on the basis of these often tenuous justifications, military and civilian pension benefits have skyrocketed since the late 1960s. Whether measured in terms of cost of payroll or replacement of prior earnings, they vastly exceed comparable retirement annuity levels available in any sector of private employment. For instance, the normalized cost of current civilian annuities is estimated at 36% of payroll, compared to a 22% cost average for combined social security and private pensions in the better private sector plans.

These excessive pension levels have had an enormous adverse impact on the federal budget. As shown below, constant dollar budget costs rose from $6.5 billion in 1962 to $38.5 billion in 1981 -- an average annual growth rate of 9.3% per year. Constant dollar pension costs have increased another 6% since 1981, and current services real costs are projected to rise an additional 12% by 1989. Stated differently, by 1989 current services federal pension costs alone will exceed 1% of GNP.

These trends make clear that the fiscal burden of federal retirement pensions must be reduced substantially in the future. With both military pay at competitive rates and new federal civilian employee coverage under social security, next year's budget will present a long-overdue opportunity to constrain the cost of existing annuities, and prospectively bring federal pension benefits in better alignment with those available to private employees throughout the U.S. economy.

TRENDS IN CONSTANT DOLLAR FEDERAL MILITARY AND CIVILIAN PENSION COSTS
(billions of constant 1985 $)

Year	Constant Dollar Budget Level
1962	6.5
1981	38.5
Average compound annual growth rate	9.6%
1984	40.8
1989 current services	45.7

6) Federal Civilian Employment

In 1985 the 2.1 million federal civilian payroll will cost $61 billion for basic compensation, health benefits, unemployment insurance and disability benefits. While considerable progress has been made in reducing excessive staffing levels in many agencies, total civilian employment remains near its 1981 level.

The detailed analysis offered by the Grace Commission of both government-wide personnel policies and individual agency staffing patterns strongly supports the presumption that

major costs savings in this area are feasible. The more promising options include more aggressive contracting out through A-76 procedures; reduced staff layering and overlap between operating bureaus and departmental levels; reduction of excessive sick leave, vacation and annual leave entitlements which would permit equal work to be done with fewer FTE's; and more appropriate job classification procedures and pay comparability methodologies.

Due to the size of the federal work-force and the high rate of attrition, it would not take draconian staffing reduction to generate significant savings over a reasonable period of time. On a fully implemented basis, a 5% reduction in the federal work force by 1988 would yield savings of $3.7 billion per year.

1985 COST* OF FEDERAL CIVILIAN WORK FORCE

(in billions of dollars)

Basic compensation	56.6
Health benefits	3.4
Unemployment insurance ...	0.2
FECA	0.8
Total	61.0

7) Improved Federal Procurement

Federal procurement costs in 1985 are projected to be $207 billion -- an 88% increase from the 1980 level. While the unique nature of many federal procurements -- particularly in the defense area -- makes cost comparisons with private sector practices difficult, there is little doubt among informed analysts that major cost reductions are possible

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* Excludes pension costs and indirect costs (e.g. office space).

with changes in existing policies and methods. Over the past three years, the Administration has launched sweeping efforts to simplify and consolidate federal procurement regulations -- and these efforts are beginning to produce tangible results.

Nevertheless, large savings depend upon basic policy changes -- most of which must be approved or supported by the relevant congressional committees. These include more extensive use of multi-year contracting, increasing the share of procurements subject to competitive bid, minimizing the impact of social policy restrictions on the procurement process, increasing accountability within procurement management organizations, simplification of product specifications for commercial type products and greater emphasis on economically optimum quantities in procurement orders.

While many initiatives in these areas have been proposed by the Administration, particularly by DOD, they have been consistently thwarted by restrictions and outright prohibitions in appropriations and authorization bills. Given both the gravity of the budget situation and the extensive list of procurement reforms proposed by the Grace Commission, a renewed major procurement reform effort in future budgets is both warranted and a promising opportunity for significant cost reductions.

8) Special Interest Economic Subsidies

Despite major progress in eliminating or reducing special interest economic subsidies over the past three budget rounds, substantial opportunities for savings still exist.

The major obstacles are the natural, parochial political pressures to retain previously granted advantages, and the more compelling argument advanced by individual interest groups that subsidies should be eliminated across-the-board or not at all.

Fashioning a consistent set of federal policy standards against which to assess local, regional and industrial sector subsidies would be a difficult and demanding task. Yet an even-handed set of criteria fairly applied could produce billions in annual budget savings. A policy framework based on user fee principles and national vs. purely local or sectoral economic benefits could be expected to reduce outlays significantly in the following illustrative areas. Most of these have been previously proposed by the Administration, but not in the context of a comprehensive policy framework:

- o capital and maintenance costs for inland waterways;
- o operating costs of the FAA air traffic control system;
- o search and rescue, inspection and licensing costs of the Coast Guard;
- o capital and maintenance costs of deep ports;
- o debt repayment and interest charges on outstanding federal loans to the federal power marketing administrations;
- o large interest subsidies to rural electric and telephone cooperatives;
- o operating subsidies for local mass transit systems and maritime operators;
- o subsidized insurance premiums offered by the Pension Benefit Guarantee Corporation and many other federal insurance agencies;

- o inadequate user fees for a variety of federal commercial inspection, liscensing and information services offered by USDA, Commerce, HUD, Treasury and many of the regulatory agencies;
- o charges and fees for use of federal lands, parks and other facilities;
- o subsidies for local economic development which merely shift the geographic location of investment and development such as those offered by EDA, HUD, Farmer's Home Administration, Corps of Engineers, and through such tax code features as industrial development bonds.

This partial list of remaining unwarranted economic subsides provides ample evidence that potential savings of billions per year are possible if an acceptable policy framework for subsidy phase-out can be developed, and intense special interest pressures overcome. To be sure, many of these proposals have been repeatedly rejected by individual congressional committees. Nevertheless, the overriding requirement for structural budget reform to bring future spending and revenues into alignment at an acceptable share of GNP necessitates that a comprehensive program to root out unjustified economic subsidies be considered in the next budget round.

POSSIBLE AREAS FOR FUTURE STRUCTURAL REFORM AND MAJOR BUDGET SAVINGS

Chairman HATFIELD. Would the Director submit a list in detail for our perusal?

Senator BUMPERS. I thank the Chairman for the suggestion, and I think the list will be edifying to all the members of the committee.

INDEXING

Let me ask you, Mr. Chairman, is indexing completely off limits for the Congress?

Secretary REGAN. No; we are willing to discuss indexing with Members of Congress and the like, but you must admit that that is one of those items that at least we would characterize as contentious because there are many on our side who really want that, including the President.

Senator BUMPERS. I think that the President——

Secretary REGAN. We have tried to concentrate it as downpayment on the less contentious items in order to get them down.

SURTAX

Senator BUMPERS. The President, as you know, proposed a surtax under certain assumptions last year. Why is that still not a good idea, only just moving it up a year?

Secretary REGAN. Again, we think we can arrive at sufficient revenues, $35 to $45 billion in just loophole closings to match spending cuts of the same amount which, with the debt interest savings, will take us to the $100 billion level. There is no need to go in for such a thing at this time.

DEFENSE BUDGET

Senator BUMPERS. Mr. Secretary, do you share the President's enthusiasm for this defense budget?

Secretary REGAN. For the defense budget?

Senator BUMPERS. Yes.

Secretary REGAN. In general, yes. I am not an expert in that area, and I haven't examined that budget in detail.

Senator BUMPERS. You know, in 1985, if you take just the interest on the debt in this budget, which will be $116 billion, and the defense budget, which is not $305 billion, but if you add, Mr. Chairman, the Energy Department, which is $7 billion, and NASA and that sort of thing, it is around $320 billion, but just use the $313 billion which is essentially atomic warheads plus the defense authorization. Of those two items alone, just interest on the national debt and defense authorization for 1985, exceeds all the personal and corporate taxes that will be collected in this country by $29 billion. Had you thought about that, Mr. Secretary, just those two items, defense and interest, will exceed all corporate and personal taxes that will be collected in 1985 by $29 billion?

The defense budget alone in 1985 will almost exceed or will equal all the personal income taxes that will be collected next year.

That's pretty staggering when you think about just one item in the budget taking up all the taxes collected in the country, don't you agree?

Secretary REGAN. Well, yes, but you also have to remember there is $271 billion which is strictly for social programs, social security, and the payroll taxes. There is also a personal tax to a great extent, and a corporate tax.

Senator BUMPERS. Well, it is, but that is all pretty much dedicated revenues, too, under our—at least our scheme of things. But in 1988, CBO says, under present projections to 1988—this really ought to be alarming to this administration, because they make so much of the 25 percent tax cut, which I happily opposed—but the 25 percent tax cut of 1981, and the increase in defense spending, of course, in my way of thinking, is our problem. CBO says that in 1988, it will require a 17 percent tax increase straight across the board, corporate and personal, just to pay the interest that has increased due to the deficits that have been approved and which have accumulated during this administration.

Secretary REGAN. I haven't seen those figures. I can't comment on them, but, of course, a lot will depend upon what their assumptions are for a tax rate increase, nominal growth of GNP, and also what the rate of interest they are assuming we would have to pay on the debt in that particular year.

Chairman HATFIELD. Time?

Senator BUMPERS. Thank you, Mr. Chairman.

Chairman HATFIELD. The Senator from Georgia.

Senator MATTINGLY. Thank you, Mr. Chairman.

OBJECTIONS TO BUDGET RECOMMENDATIONS

I don't believe the basic questions have been answered. I think everybody agrees that your recommendations in the budget will be met with parochial answers when it comes time to make budget cuts be they farm subsidies, military construction or IDB or whatever.

The objections may be in Southern, Western, Eastern, or Midwestern accents, but there will be objections.

I think we avoid our responsibility when we do that. We can't allow ourselves to be manipulated by all the people and special interests that are indebted to the Federal Government. When we were elected to office, we promised to take action. Obviously, we have not done so. I think it is ridiculous to even refer to this proposal as a "budget." But what are we going to do with it now that we have it?

I know that Secretary Regan is supposed to be out looking for tax reform, which is fine, but we still have never addressed how we are going to reform the entitlement programs, all the indexed programs.

What about a spending commission to look at the whole spending reform side of this budget and come back with a package next year? I would like for the three of you to address that. I mean, we are going to be right back here in 12 months doing the same thing again. We have

done it 3 years in a row now. When are we going to address total reform in spending?

Why can't we set up a special commission, just like the President wants to do with your tax reforms?

Mr. Feldstein?

Mr. FELDSTEIN. The tax reform is not to be done by the commission.

Senator MATTINGLY. OK.

Mr. FELDSTEIN. But that is the distinction. The purpose of the bipartisan negotiations is to do it very quickly, to do something in the spring on outlays and revenues, as a downpayment; something that is not contentious, something that requires bringing together the ideas that were already agreed to within the Congress.

But to make major reforms on the tax side or major reforms on the spending side, isn't something that should be delegated to outsiders. I think it is the administration's responsibility to come in with its plan for how to raise $1 trillion a year in taxes and its plan for how to spend money on that order of magnitude.

SPENDING REFORM PACKAGE

Senator MATTINGLY. Let me ask you a question. Since the President has asked the Secretary of the Treasury to come up with a tax reform package, why shouldn't we then have him ask somebody to come up with a spending reform package?

Mr. FELDSTEIN. I don't think there is any harm in his doing that. In fact, that is, of course, what automatically will happen over the months ahead as the agencies think about what they would do in a postelection year.

Senator MATTINGLY. Do you believe that will happen?

Mr. FELDSTEIN. I believe some of that will happen.

Senator MATTINGLY. Do you believe a total spending reform package will be proposed?

Mr. FELDSTEIN. We are really speculating about what 1985 is going to look like after the election. I assume——

Senator MATTINGLY. Wait a minute. Every 2 years there is an election.

Mr. FELDSTEIN. A Presidential election is every 4 years.

[Laughter.]

Senator MATTINGLY. I remember that.

Mr. FELDSTEIN. It would not be surprising if, after that election, the President were to pull together the ideas that he wants on the tax side and the ideas that would then be put together on the spending side.

Senator MATTINGLY. Why don't we begin to look at the ideas now on the spending side?

Mr. FELDSTEIN. I don't have any objection to it.

POLITICS A BLOCK TO DEFICIT REDUCTIONS

Mr. STOCKMAN. Senator, if I can come to the rescue of my colleague here. You know, for 36 months we have been coming up here tossing spending reform idea after spending reform idea into the hopper. A good many of them have been adopted and we are better off as a result. But a lot of them have been rejected, and a lot that we haven't formally endorsed or proposed have been discussed at length. I would like to suggest that your problem is not lack of solutions or options or a failure of expertise. The problem is politics. The problem is the accents that you talked about, the very different interests of different parts of the country, of different regions, of different ideologies and so forth. So it seems to me that rather than have another commission, what we ought to be doing is to figure out how we can overcome the politics that stand in the way of a package that is big enough to reduce this deficit.

Senator MATTINGLY. You have been in Washington longer than I have and you haven't overcome politics yet?

Mr. STOCKMAN. That is the only way to get there, and I can tell you that right now. This budget is a hostage to politics. It will keep growing over and over; that is what is built into the current spending and revenues. Unless we can overcome revenues, it is going to be there and get worse.

Senator MATTINGLY. I agree with you. Say we don't get a commission. If we are going to go after tax reform, then why shouldn't we go after a package of spending reforms?

GRACE COMMISSION

Mr. STOCKMAN. The Grace Commission just proposed $400 billion. There is a lot of meat in there. I think there are things in there, including a lot of those Farmer Home Administration programs that are highy supported in some regions of the country. There are a lot of other things in there that we probably could do. You have got 3 years of budget recommendations that we have made. Some of them are still unenacted. I don't think that there is any shortage of ideas for reducing the budget.

SOCIAL SECURITY EFFECT ON BUDGET

Senator MATTINGLY. But you and I both know half of the budget goes into entitlement programs.

Mr. STOCKMAN. That is calling a spade a spade. Social security, what are you going to do about it?

Senator MATTINGLY. Half the budget goes into entitlements.

Mr. STOCKMAN. No, social security.

Senator MATTINGLY. Half of it is social security.

Mr. FELDSTEIN. Half of all nondefense spending is social security and medicaid.

Senator MATTINGLY. But there are many entitlement programs, is that right?

Mr. STOCKMAN. Almost all of it is social security.

Senator MATTINGLY. Do you think it ought to be addresssd?

Mr. STOCKMAN. We addressed it last year. We passed an historic reform.

Senator MATTINGLY. Then according to you there is not going to be any answer.

Mr. STOCKMAN. I am talking about nondefense spending.

Senator MATTINGLY. I am saying that there are also entitlement programs in defense and elsewhere in the budget.

Mr. STOCKMAN. Military retirement.

Senator MATTINGLY. That is right.

Mr. STOCKMAN. That has been moved out of defense.

Senator MATTINGLY. It is still in the budget, isn't it?

RETIREMENT PROGRAMS

Mr. STOCKMAN. Let's just put it in proportion: Social security is about $200 billion, military retirement $17 billion, civil service retirement $121 billion. So those are your three big retirement programs.

Senator MATTINGLY. Then there are others.

Mr. STOCKMAN. Then there is medicare and medicaid that we have been working on; that's $100 billion.

Senator MATTINGLY. That is right. So you have got roughly half the budget composed of entitlements. You are saying it is half social security. It isn't half of social security.

Mr. FELDSTEIN. It really is. If you take the social security programs—the old age and survivor part, the disability part and the medicaid part—in fiscal year 1985, you are talking about $262 billion of outlays.

SPENDING REFORM PACKAGE

Senator MATTINGLY. I don't want to quibble with you about the details. You and I both know that the budget isn't going to be balanced or even come close to being balanced until you package all this up and try to come back with some fundamental spending reforms. Do you agree?

Mr. STOCKMAN. Yes.

Senator MATTINGLY. You sure are not going to rely on the Congress to do it, are you?

Mr. STOCKMAN. I sure am.

Senator MATTINGLY. I am sorry to hear that.

Mr. STOCKMAN. Because if you put some experts together, they will put together a nice package that will never get adopted.

Senator MATTINGLY. Would you recommend to the President, then, that we get started on it now?

Mr. STOCKMAN. I think we are trying to do that as much as we can in this bipartisan negotiation. We are not going to experts. We are going to the elected leadership of the House and Senate, the politicians who are going to have to solve the problem.

Senator MATTINGLY. All right. I am just saying, establish another group and start now on spending reform and not wait until a year from now?

Mr. STOCKMAN. Let's get the first step down first and then we will worry about the second one.

Senator MATTINGLY. You mean there is not enough brain power up here to get two groups going? [Laughter.]

Mr. STOCKMAN. Well, don't ask me to answer that. [Laughter.]

Senator D'AMATO. Where I come from, they call it something else. [Laughter.]

Senator MATTINGLY. Don't you think there really are enough people up here to do that?

BIPARTISAN WORK ON DOWNPAYMENT

Mr. STOCKMAN. I think there are. I would hope that while some people are working on the downpayment, which is very dry, nitty-gritty unglamorous stuff, the others will be working on next year's package.

Senator MATTINGLY. What do you think, Mr. Secretary?

Secretary REGAN. I don't think it is in process now. To sort of tie up these issues, naturally, you would be off to a fine start in 1985 rather than waiting for that. But I agree with Dave Stockman; we have got to get first things first; we have to get the downpayment. If we don't get the downpayment, we have no hope of getting anything next year.

Senator MATTINGLY. You have got your group working on tax reform.

Secretary REGAN. That is right.

Senator MATTINGLY. You have got another group working on the $100 million downpayment. I think there are enough people to work on another group.

Chairman HATFIELD. Thank you, Mr. Mattingly.

Senator from Missouri?

Senator EAGLETON. Thank you, Mr. Chairman.

LINE ITEM VETO

Secretary Regan, you had a discussion with Chairman Hatfield about line item veto. That aroused my curiosity. Is the line item veto that the administration is recommending similar to the one that many States have? It is an all or nothing veto, you get to the line, you put an "x" for it, or the line holds, or if I heard you correctly, alternatively, is it an adjustment kind of a veto where, instead of $2 billion, you can put in $1 billion?

Secretary REGAN. It is the first type that we have been referring to where a blue pencil, as it were, would be drawn through a particular item.

Senator EAGLETON. So you couldn't line item veto the Internal Revenue Service, even if you thought the figure was grossly exaggerated and we give you too many agents, you couldn't possibly put a blue pencil through IRS or FBI.

Secretary REGAN. I would agree to that, Senator, although I might say, sardonically, there are many who might welcome such a move.

Senator EAGLETON. On April 15?

Secretary REGAN. Yes.

Senator EAGLETON. Assume we give the President line item veto authority, and assume secondarily that we enacted the President's budget as is, not making one change, and give it to you as you have submitted it.

Are there items that you would recommend to the President on the line item veto?

Secretary REGAN. No, not currently, Senator, because this is the President's budget. He submitted it. I doubt if he would want to knock out any particular item at this point.

Senator EAGLETON. I think that is an honest answer, and I commend you for it, but it points up the hypocrisy of the President's recommendation.

Secretary REGAN. Not necessarily, Senator, because at least in the 3 years that I have been here now, watching these budgets come up and be rejected, we never get back the same document we send up. So my assumption would be that the budget eventually sent by the Congress to the President will include items that the President would want to reject.

Senator EAGLETON. If we gave you everything you wanted, it would end up with a deficit of $180 or $183?

Secretary REGAN. Currently, $180 billion if you gave us everything we wanted. You would also want to knock off another $100 billion approximately over the next 3 years, including about $20 billion more in this year.

BALANCED BUDGET RECOMMENDATION

Senator EAGLETON. While we are on this area of restructuring government, line item vetoes and the like, do you see even a tinge of hypocrisy in recommending the constitutional amendment to balance the budget at the same time your budget submittal calls for deficits of $813 billion over the next 5 years?

Secretary REGAN. No, again, I don't, because, first of all, from a practical point of view, even if the Congress were to adopt the balanced budget amendment this year, I think it would be at least 4 years before it would go into effect.

By that time, knowing that it was coming, we would have to come to grips with many of the spending and revenue problems that are afflicting the budget right now.

Senator EAGLETON. If the constitutional provision were in effect today, from an economic point of view and a financial market point of view, could you balance the budget today?

Mr. FELDSTEIN. We wouldn't have been in this position if the amendment had been in the Constitution in the past. You couldn't have gotten to this kind of a structural deficit by the procedures of that amendment.

Senator EAGLETON. The administration wants the amendment, wants it as quickly as possible, and I am posing the question, if you had it today, what would you do with it?

Secretary REGAN. Presumably, the effective date of the amendment would reflect an adjustment period. Thus, an amendment requiring a balanced budget by the fiscal year 1985, would have been anticipated over the years 1981, 1982, 1983, and 1984 and presumably we have had the budget experience in those years that would enable us to achieve a balanced budget by this year.

Senator EAGLETON. With the constitutional amendment, when do you think the budget can be balanced?

Secretary REGAN. It depends upon when the balanced budget amendment would come in. What we are shooting for, in the statements that the three of us have been making, is that assuming the downpayment this year, plus this budget, and with more deficit reduction to come next year, we certainly will be somewhere well below 2 percent of Gross National Product, by the late 1980's, and that is not far from balance.

So I would assume that if a balanced budget amendment were in effect in 1988 or 1989, we would make it.

Senator EAGLETON. If I may, under current circumstances, with or without a constitutional amendment, and current means we don't have it, and I hope we never have it, because under current circumstances, could Houdini balance the President's budget?

Mr. FELDSTEIN. He would be doing a great disservice if he balanced it in 1985; because economically it would be a mistake to try to take the deficit from $200 billion down to zero, because it would knock the economy down on its back. It has got to be done over time. It has got to be done with regard for the appropriate lags for getting private demand to grow; on the investment side, on the export side; this will replace the budgets which are currently crowding out that spending.

BLAIR HOUSE BUDGET NEGOTIATIONS

Senator EAGLETON. My final line of questioning deals with these negotiations, Secretary Regan, that are going on at the Blair House or went on this morning, the first phase.

What is on the table? What are they starting with in the negotiations, the proposals in the budget, or is there a package of other proposals that you have in your briefcase on behalf of the administration?

Secretary REGAN. No. It is mainly along the same lines of the things that we have already suggested in here, and by the way, I misspoke just a moment ago when I told you we could reduce by another $20 billion.

Many of the items that are on the table in the discussions are already in here, probably about 50/50, so reductions wouldn't be quite as much as $20 billion in the first year from this baseline of a $180 billion deficit.

The other suggestions that we have, again, are along the same lines as these. There is nothing novel or very different from the type of sugges-

tion we have made in spending cuts, that Dave has already enunciated in answer to the previous questions or some of the loopholes that I have discussed in answer to previous questions also.

INDEXING

Senator EAGLETON. Not to belabor the point, but anything on the table, you were asked, for instance, about indexing, and you said that you were making no recommendation about it, but it is on the table.

Secretary REGAN. No, that was brought up this morning, not by us, obviously, but that was brought up, and we said, sure, we will discuss indexing.

Senator EAGLETON. And other forms of taxes over and beyond the loopholes used in this budget?

Secretary REGAN. Yes. As a matter of fact, one of the suggestions was, should we do something about going back and revising the third year. And we said, we will discuss it. We think it is probably futile, but we will discuss it.

Chairman HATFIELD. The Senator from New Hampshire?

Senator RUDMAN. Thank you, Mr. Chairman.

One of the requests of sitting way down at this end of the table is usually it is about time to change the subject.

I do have a line of questioning that I will keep very brief for Mr. Feldstein. I just want to say first to Mr. Stockman, in reading your Fortune piece, which I think was beautifully honest, reminds me of Will Rogers when asked if most of the fellows in Congress were lazy scoundrels, Rogers answered yes, that is probably true, and they probably also truly represent their constituency. [Laughter.]

MIDDLE CLASS ENTITLEMENT PROGRAMS

Senator RUDMAN. You are saying today, if you read between the lines, and you said in the Forture article, and I happen to agree with you, that the American people like big government in the form of middle class entitlement programs.

Are you not saying that?

Mr. STOCKMAN. Senator, I am saying that if you were to assess the experience we have had over the last 3 years, the resistance that is issued at certain points that we have made, proposals that seemed to be justifiable and valid, you can conclude that.

But on the other hand, the difficulty is in our political process. The ultimate question is never posed to the public.

When it comes to a final choice, do you want to have lower taxes or all of that public service and spending? You cannot have both, and it is never really sharpened and posed in that bottom-line way.

I think one of the things that we in government ought to do in the coming months is to impose that choice. Until we have, we cannot give any final answers.

Senator RUDMAN. That is precisely the answer that I would give to my question. The fact of the matter is that last month, there were a

number of polls done by major organizations. Four out of five of the American people totally oppose any major new tax increases. Three out of four oppose any major cuts in entitlement programs. Two out of three oppose any cuts in social programs, and we all sit here year after year after year and ask each other these same questions and get essentially the same answers.

As far as I am concerned, we could play a tape recording of the same hearing last year. The fact of the matter is the reason the President hasn't proposed it and the reason the Congress won't take the first step is that the American people right now will not support major spending reform in the entitlement programs.

That is the only way in the long term future to balance this Federal budget; is that correct or incorrect?

Mr. STOCKMAN. I would say that is more in the way of a philosophical observation.

Senator RUDMAN. Do you agree with that observation?

Mr. STOCKMAN. I wouldn't be prepared to concede that that is absolutely the case.

Senator RUDMAN. I would say to you that in Fortune magazine you agreed to that almost point to point, because it is almost a general recapitulation of what you said, Mr. Stockman.

I want to turn to Chairman Feldstein. Your economic report to the President, dated February 2 of this year, is a very interesting document, and I intend to read it fully.

I want to go over one very small portion of it, because I believe it poses a real dilemma for those of us who have to face the question, and you raise it very well, Mr. Feldstein.

U.S. ACCOUNT DEFICIT

You say in 1984, the United States current account deficit is forecasted to be roughly 40 percent the size of the Federal budget deficit. This means that a capital inflow from abroad is financing the equivalent of 40 percent of the budget deficit and the crowding out of other sectors of domestic credit demand is reduced correspondingly.

The national capital flows of this magnitude are consistent with the increasing integration of world capital markets. Then you go on beyond that to discuss the benefits and, if you will, the down side of that situation.

U.S. TRADE IMBALANCE

One of the things that we are facing with this whole deficit situation is the horrible imbalance of payments that we have at this time in export trade, but it seems to me we are in kind of a Catch-22 situation, and I wondered if you and the Secretary might comment on it. That is, if the fact that the dollar weakens and we help our exports, at the same time, there is apt to be a substantial outflow of capital and thus, the amount of foreign financing of this debt that we have right now is apt to really shrink, thus shrinking the domestic money supply and driving up domestic interest rates?

I would just like you to comment on that, if you could?

Mr. FELDSTEIN. I think what you said is basically correct. There would be less of a capital inflow; there would be less credit available in these markets. Interest rates would rise, especially long-term real interest rates would rise.

It is a Catch-22. It is a no-win situation. The large budget deficits are pushing up real interest rates and making the dollar very strong. The capital inflows are reducing the pain on our domestic interest-sensitive industries, but they are hurting our export industries and those competing with imports from abroad.

If the dollar comes down without a real reduction in the budget deficit, then we will see less pain to our trading industries, but more pain to our domestic interest-sensitive industries. That is why it is so important to make progress now in dealing with these future budget deficits and to come back and make substantially more progress. If the financial markets expect future deficits to come down, then we will get the combination that we like, namely lower interest rates and a more competitive dollar, because the market that is looking ahead will not expect to see the Government in there grabbing up such a large share of the available funds.

Senator RUDMAN. But if, in fact, we do not make the kind of structural changes which is the only chance in which we will ever bring these deficits down in a significant way, and we move into the year 1985 in this situation, should there be, for any reason, a weakening of the dollar, that would accelerate the possibilities of domestic recession.

Do you agree with that?

Mr. FELDSTEIN. Yes, I do. That is very correct, very perceptive.

POSSIBLE DOWNTURN IN ECONOMY

Senator RUDMAN. My last question, Dr. Feldstein, is simply this: We all talk as though we are sitting up here with the fine controls of a jet aircraft and micromanagement, everybody says we will take care of this in 1985.

I would like to ask you a question: If you had to do some risk assessment, what kind of risk is there between now and the end of this calendar year that we could start to see some signs of a down turn in the economy? What are the possibilities of that?

Mr. FELDSTEIN. I think that within this calendar year the risks are quite low, but the conditions that could lead to future trouble, particularly the conditions you refer to, could, indeed, start at any time.

Senator RUDMAN. Isn't that, in fact, one of the very concerns that nobody is talking about, the very point that we have discussed?

Mr. FELDSTEIN. I think it is not fully understood. People are so keen to get the dollar down, that they don't realize there is a good way and a bad way. The good way is to do it at a time when expected budget deficits are coming down, because that could be accompanied by lower interest rates. The bad way is because of a change of sentiment or confidence in the world, that the large budget deficits predicted will persist, and that will push interest rates up.

Senator RUDMAN. If that were to happen in the first quarter of 1985, we would be in one devilish roller coaster, and that is precisely what some of your bretheren in your profession are saying is apt to happen in 1985; is that correct?

Mr. FELDSTEIN. There are those who worry about that, and it could, indeed, happen.

Senator RUDMAN. And some pretty top-notch people, in fact.

Thank you.

Chairman HATFIELD. Thank you, Senator.

The Senator from Wisconsin?

Senator PROXMIRE. Thank you, Mr. Chairman.

Well, gentlemen, I am delighted to see this harmony today. I expected to see some real fireworks, and I thought that you gentlemen were going to disagree and you have been harmonious and agreeable, and I haven't heard one word in which you disagree with each other at all, so either the press is wrong or something is wrong here or maybe we just haven't stimulated you enough.

Let me see if I can do that. [Laughter.]

DEFICIT CUTS

Senator PROXMIRE. Do I understand that all of you gentlemen agree that unless we cut the deficit below the President's $180 billion deficit, cut that deficit further, they cut it, rather, we will not have the rosy consequences that are contained in the budget of a drop in T-bill rates from 9 percent to 5 percent and mortgage rates from 12.5 to 7, a continued drop in unemployment at the same time, and moderate level of inflation at around 5 percent for the next 5 years?

Do you all agree that, in other words, that the President's budget, as he sent it to us, will not provide that kind of economic consequence?

5-YEAR PROJECTION

Secretary REGAN. What time span are you talking about, Senator?

Senator PROXMIRE. What is that, sir?

Secretary REGAN. What time span?

Senator PROXMIRE. I am talking about the next 5-year period in which the budget was submitted.

Secretary REGAN. Five-year period?

Senator PROXMIRE. Yes, sir.

Secretary REGAN. I would say from my point of view that we do run a grave risk, if these deficits aren't brought below what we are suggesting here, of having the economy in the future much weaker than it is currently.

Just how far in the future I don't think anyone can really project, because projecting in 5 years is an extremely difficult task.

That is why, I think, the President has accompanied this budget message by a request that more be done by having it this way.

ECONOMIC ASSUMPTIONS

Senator PROXMIRE. We run a grave risk, but nevertheless, you don't want to call it predictions, you deny that they were predictions, but you have, accompanying this, an indication that you believe that this is consistent with a fall in interest rates and these other happy followings.

Mr. FELDSTEIN. Let me repeat what I said in my opening remarks. The economic assumptions—we label them economic assumptions as the CBO does—are conditional upon getting sharply declining budget deficits and sound monetary policy over this period.

Certainly, I believe that we cannot have this progress on interest rates, inflation and real growth that we assume in the budget calculations unless we have substantial reductions in the deficit, beginning with this downpayment.

Senator PROXMIRE. And you do not believe that the budget document as submitted will give us those sharply declining deficits; is that correct?

Mr. FELDSTEIN. I believe we have to go beyond. We have to get the deficits that are called for in the budget document and go beyond it, both now in these negotiations and the followup in 1985.

Senator PROXMIRE. Mr. Stockman?

DEFICIT REDUCTIONS IN THE OUTYEARS

Mr. STOCKMAN. I think I basically agree with what has been stated. Your question is, can we stay on the economic assumption path in this budget all the way through 1989 if nothing is done in 1986, 1987, 1988 or 1989 and beyond what we have proposed, and the answer is no. I think we all agree that in the outyears more has to be done. But for 1985 we believe that the forecast for the economy is reasonable.

Senator PROXMIRE. We are moving in a precedent here, that in a presidential election year, the President will submit a budget that doesn't really reflect his views; that won't give us the results that he expects, unless Congress does more and comes up with—negotiated with him in a way that will get him off the political hook such that you end up with a lower series of deficits.

FIVE-YEAR BUDGET PLAN

Mr. STOCKMAN. Senator, if I can respond to that I will say yes, because there is something new in the picture we have never had before.

The income tax rates were increased in the last presidential election. Everybody thought 8 and 9 percent inflation would be good forever. The 5-percent reduction would show a surplus for outyears, so nobody had to ask Congress to do anything in the outyears. We are now in a new process of dealing with the outyears. We have a tax code for the taxpayers because if we are going to spend more in 1985 we ought to ask them directly for it in taxes. No President or presidential candidate has ever had to deal with that kind of a 5-year budget before.

Senator PROXMIRE. I am not sure that answers my question.

My question is, we would have a document submitted by a President on the year of his election and then have him say, we are really going

to do what we have to do over the next several years, we have to meet and negotiate some kind of change in the budget.

Running for election this year, I don't want to have to take the burden of having to impose unpopular tax increases or spending reductions. That is what he is doing.

Mr. STOCKMAN. I don't know how you would characterize it. I just know that as Marty said before, we proposed a 5-year plan last year that had $400 billion worth of deficit reduction in it: $170 billion in higher taxes, $180 billion in spending reductions, and the remainder in debt service savings.

We said if you do the spending, we will accept the taxes. We argued and shouted for a year and you didn't do the spending. Taxes didn't get done. The deficit is as large now as it was last spring when this hearing was held. So we are trying a different approach, which is more modest, but based on what is reasonable to get done in this environment that we cannot make go away; namely, everybody is up for election.

Senator PROXMIRE. Dr. Feldstein, let me see if I can follow up a question that Senator Rudman asked:

If the dollar declines and foreign investment drops, you say that the lack of this money coming in will adversely affect the economy and sharply affect it.

What happens if the Fed steps into the breach and provides the difference? Is it highly inflationary?

Mr. FELDSTEIN. It would be highly inflationary if you try that.

Senator PROXMIRE. Why is that?

Mr. FELDSTEIN. If you are talking about an increase in funds from the Fed, this would dramatically increase the money supply. What comes from abroad doesn't increase our supply of money, M–1 and M–2, but a change in the rate which increases the ability or willingness to have credit, and the willingness to buy bonds, Government bonds, and the willingness to buy stocks that are held by Americans now. That cannot be replaced by simply having the Fed increase the supply of money.

Senator PROXMIRE. So it is the hard, tangible goods coming in, is that it?

Mr. FELDSTEIN. Well, no, it is the willingness to lend; it is the willingness to buy bonds, to buy stocks issued by American companies, to buy mortgages issued by American institutions, that provide the funds that the Europeans and others from around the world are providing. It is the credit.

Senator PROXMIRE. Secretary Regan?

Secretary REGAN. I think there are two other things, also, that you have to keep in mind in your equation, Senator.

First of all, in the demand for money, what is the situation on the demand side? If the dollar is, indeed, falling, as Dr. Feldstein said, if it were falling for the wrong reasons, lack of confidence and the like, there might not be the demand for dollars that there would be in a strong economy.

At the same time, you have to consider what is happening in terms of the State and local situation. They are very much in surplus to the tune of some $50 billion that offsets part of the Federal deficit from the standpoint of total savings.

Senator PROXMIRE. That is why I think we ought to count on revenue sharing.

Secretary REGAN. They are sending it to us, probably.

All of those things have to be factored into the equation. There is no simple answer on that, as you know.

FOREIGN DEBTS

Mr. FELDSTEIN. Let me add one other fact. This year, foreign debts will net about half the investment in the United States. If we didn't have the capital inflows, we would have to cut back.

Senator PROXMIRE. About 2 percent of our GNP.

Mr. FELDSTEIN. That is right.

Senator PROXMIRE. I am surprised that in spite of the opening we just had, in the face of the fact that the Grace Commission was brought up, that is a spending commission, is it not? Maybe it did mention, but I didn't see it. Is there part of the Grace Commission recommendations anywhere in this budget, and is that something that might be pushed on the table and discussed in the negotiations?

GRACE COMMISSION RECOMMENDATIONS

Mr. STOCKMAN. I think that would be a good idea. Some of the Grace Commission recommendations we knew last year are in this budget. But the full package wasn't available until after the budget had been closed and gone to print. So that is another reason for the negotiation.

I don't think that everybody is going to buy off on 100 percent of what is in there or accept the magnitude of the number, but it seems when you have got 500 recommendations and $400 billion worth of ideas, we can pick and choose out of that and find some additional savings.

Senator PROXMIRE. You would certainly call that a commission on spending, would you not?

Mr. STOCKMAN. Yes, I mentioned that to Senator Mattingly.

Senator PROXMIRE. I didn't hear that.

Mr. Stockman, you told Senator Rudman that the American public had never been given the opportunity to choose a cut and spending coupled with a cut and in taxes. As I recall, 3 years ago, it was suggested by a number of us that the two be coupled and that we not approve a tax cut in the absence of a spending cut.

The administration ignored that advice. Isn't the deficit picture we face today the result of not heeding that advice?

HIGHER PUBLIC SPENDING VERSUS LOWER TAXES

Mr. STOCKMAN. I didn't quite say that. I said that the choice of higher public spending or low taxes never had been explicitly and starkly posed. Now you suggest, somewhat differently, that the original plan should have been more closely linked, that we should have linked in greater detail and magnitude the spending cuts with the tax reduction.

We would have been delighted at the time to have Congress agree to more spending cuts, but that was the best we could do in 1981. So I don't think it is helpful to reopen history and say we should have done it differently. Maybe you were right, but we couldn't get you to agree to any more at the time. We proposed a lot more.

CYCLICAL AND STRUCTURAL DEFICITS

Secretary REGAN. If I could add just a footnote to that, Senator, one of the things you have got to remember in our discussion of deficits here is that we have gone through a major recession, and a lot of this deficit is cyclical rather than structural, and many of the dollars that we are talking about right now have come about as a result of that recession.

Hopefully, in the future, if we get to a full employment, less of that type of deficit will occur, and we can tackle the structural part together.

Senator PROXMIRE. I see my time is up, but it seems to me that we always have, unfortunately, recessions. They are going to come along from time to time. We cannot expect to keel business over.

My time is up.

LOW INCOME ENERGY ASSISTANCE

Chairman HATFIELD. Let me just pose one last question as a follow-up for the record relating to low income energy assistance.

In light of the fact that some States are going to be depleting their funds, even perhaps within the next few weeks, has there been any indication by the House leadership that they would be willing to move this as an urgent supplemental?

Mr. STOCKMAN. Senator, there hasn't been any discussion on procedure. I think we have money available for the third and fourth quarters. The costs could be reallocated. I will have to check that, so there wouldn't be the need for the urgent supplemental action per se, but, certainly, we are going to meet the needs of the States as they come in.

SUBMITTED QUESTIONS

Chairman HATFIELD. I thank you. There will be other questions submitted to you gentlemen in writing for the record, and we would appreciate a response to those questions by February 17.

[The following questions were not asked at the hearing, but were submitted to the Department for response subsequent to the hearing:]

QUESTIONS SUBMITTED TO SECRETARY REGAN

BORROWING OR TAXES

Senator Hatfield: Mr. Secretary, why do you believe that it is better to finance federal activities through increased federal borrowing rather than through raising revenues?

Secretary Regan: The choice is between undesirable alternatives. The damage has already been done by an excessive rate of government spending. It is government spending which diverts resources to the government from the private sector, whether financed by borrowing or taxing. Raising taxes has the further effect of reducing the after-tax return on productive activity and draining funds from the private sector. Borrowing also drains funds from the private sector, but probably does so in a more efficient manner. Treasury securities are primarily sold on an auction-basis in highly competitive markets and the securities are purchased voluntarily. Taxes do not involve a voluntary market exchange and are more likely to affect incentives to work, save and invest in an adverse fashion.

The best course of action is to reduce government spending into conformity with tax receipts. Federal outlays are currently 25 percent of GNP, well above normal historical relationships. Tax receipts are about 19 percent of GNP in line with the normal relationship, despite the Reagan tax cuts. It is government spending that is too high, not taxes that are too low.

DEFICITS

Senator Hatfield: Mr. Secretary, you are testifying on behalf of this budget submission and the deficits it contains.

What are the economic arguments you intend to use with the people on Wall Street who say these deficits are too high?

Secretary Regan: We agree that the deficits are too high, although they are projected to decline as a percentage of GNP from 6.1 percent in 1983 (6.4 percent including off-budget) to 3.9 percent in 1987 (4.1 percent including off-budget). Therefore, the President has proposed that a bipartisan effort be made to cut the budget by at least $100 billion over the next three years. This would be a down payment, followed by more budget cutting actions after this year's elections.

The federal deficit was financed in 1983 without undue difficulty or extreme pressure on the financial markets. Most financial market experts believe that will be the case this year as well. Corporate cash flow has been greatly expanded by the recovery of the economy and the beneficial impact of the 1981 tax legislation. Therefore, net corporate financing requirements remain relatively modest. Difficulties would indeed arise if federal deficits remained very large at a time when private borrowing was moving to peak levels. That risk must be avoided. But it lies in the future and action along the timetable suggested by the President can prevent any serious financial market difficulties.

Senator Hatfield: Mr. Secretary, given President Reagan's announced commitment to a balanced budget by the end of his first term in office, why does this budget submission include spending and revenue totals that stray so far from that goal, even in 1989?

Secretary Regan: About $100 billion of the current budget deficit is due to the recession of 1981-82. This set back the timetable for budget balance. In addition, it has been much more difficult to reduce the growth rate of federal spending than originally anticipated. For example, the March 1981 budget projections of this Administration called for receipts to be 19.5 percent of GNP in fiscal year 1986 -- the last year in the 1981 projections. The current budget document estimates that receipts will be 19.3 percent of GNP in fiscal year 1986, a small discrepancy in such projections. On the other hand, the target outlay ceiling in the March 1981 projections for 1986 was 19.0 percent of GNP. Budget outlays were 24.7 percent of GNP in fiscal year 1983 and are projected to decline only to 23.4 percent of GNP by 1986. Receipts have held very close to their projected path but outlays have run well above target.

Senator Hatfield: Mr. Secretary, if the President had had line-item veto authority last year, what specific programs would you have recommended for veto in our appropriation bills?

By how much would that have reduced the $184 billion deficit you predict in 1984?

Secretary Regan: I do not wish to speculate about spending decisions that can't be changed because the President doesn't now have the line-item veto authority. If the Constitution is amended to provide that authority, at that time, I am certain the President would use such authority if he thought an appropriation for a particular activity was inconsistent with his spending priorities as indicated by his budget requests.

Senator Hatfield: Will you ask that the Administration's proposal for a line-item veto apply to tariff, revenue, entitlements and other authorizing measures as well as to appropriation bills?

If not, don't certain revenue measures contribute to the deficit by reducing receipts? Don't certain entitlements increase outlays?

Secretary Regan: There are a number of bills pending in the Congress that give the President line-item veto authority. The scope of these bills is wide. The Administration is not committed or locked into a particular concept for a line-item veto authority. We are willing to work with the Congress to develop the specific coverage to which such authority should apply.

Senator Hatfield: Last year, Congress cut a deal with the Administration. In return for the $8.5 billion in IMF funding that you wanted, we got a revised housing authorization bill. What is the likelihood that the Administration would have gotten its $8.5 billion for the IMF, if members thought the compromise package would be rewritten downtown before being signed by the President?

Secretary Regan: The Administration supported the housing and IMF authorization compromise bill as it was passed by Congress and would not have altered or withdrawn its support once the bill reached the President. There was no question of the Administration's commitment to the bill and consequently no basis for the Congress to have questioned signature of the bill as it was passed by Congress.

Senator Hatfield: Let us assume that the line-item veto had been in place last year. After the adjournment, the President uses his line-item authority to veto spending for EDA, postal service subsidies, and the Legal Services Corporation. On the first available vehicle after reconvening, the Congress passes a supplemental bill that provides funding for these three programs and rescinds the recently enacted IMF funding authority.

The President then has the option to use his veto authority or line-item veto authority. By having a line-item veto power, in this hypothetical situation, has the President enhanced or diminished his ability to enact his spending priorities?

Secretary Regan: Assuming that the supplemental bill in your hypothetical situation contains only the items you mentioned, i.e., spending for EDA, postal service subsidies, the Legal Services Corporation, and IMF funding authority, line-item veto authority does not enhance or diminish the President's ability to enact his spending priorities. In this particular example because he would oppose the Congress' position on all the items in the appropriation bill, either a line-item veto or the veto authority he now has would accomplish the purpose of seeking to enact spending amounts consistent with his program priorities.

In many instances, however, the President is not faced with this type of situation. Usually, he must make a choice between vetoing an entire appropriation bill to object to higher or lower spending for one particular program or signing the bill to get the amounts he desires for most of the programs financed through the particular appropriation bill in question even though he objects to one or more provisions. Line-item veto authority in such a case would strengthen the President's hand in dealing with this type of situation because unlike with his present veto authority he could pick and choose among the appropriated amounts and veto only the one(s) to which he objects.

SIMPLIFORM TAX REFORM

Senator Hatfield: Mr. Secretary, I am delighted that your statement has emphasized so heavily, the need to simplify the individual income tax structure.

I concur entirely that the growing level of citizen unrest with our tax system is compounded by the continuing erosion of our revenue base, which if unchecked, will further exacerbate our efforts to narrow the staggering deficit gaps we face in the 1980's.

My question, Mr. Secretary, is whether you propose that Simpliform income tax changes be used as a means of raising revenues to apply against the growing national debt or instead to simply stabilize the current erosion of the tax base?

FOLLOW-UP As you may know, since 1972 I have advocated simplifying the tax structure by eliminating or "capping" many of the deductions and credits which have proliferated within the tax code. At the same time, I have proposed lowering the marginal tax rates which apply to all income brackets. The net effect is to retain the most basic tax deductions which middle income earners have come to expect but curtail the tax base erosion caused by expanding tax deductions.

As you may know, I have transmitted to the President an article which appeared in the January 30, 1984 issue of Tax Notes regarding my Simpliform Tax Proposal. I provided a copy as well and invite your comments and ask that you consider the proposal during your deliberations on the Simpliform Tax Proposal.

Secretary Regan: By the end of 1984, the Treasury Department will have completed a study of basic tax reform, and we will be making our recommendations for changes to the Congress.

Tax reform itself involves changes--most likely including a broader tax base with lower tax rates--to make our tax system more efficient, more equitable, and better able to promote economic growth and stability of the U.S. economy. Under a reformed tax system, some people will pay somewhat more taxes than now, others will pay somewhat less.

Obviously, what we learn from the tax reform study would be relevant if taxes need to be raised -- or lowered. But the real purpose of our study is to reform the existing tax system at its existing level of revenue. Any tax increase or decrease would be a separate issue.

Of course we will be pleased to take a look at your tax reform proposal during our deliberations.

TAX AND REVENUE --- INDEXING

Senator Hatfield: If by some chance Congress and the President decided to repeal or defer tax indexing, what would be the revenue increase to the Treasury annually between 1985 and 1989?

Secretary Regan: Indexing of the income tax is scheduled to begin for calendar year 1985. If the indexing provision were to be repealed--which this administration opposes, we estimate that the income tax system would raise an additional $144 billion of revenue between Fiscal Year 1985 and Fiscal Year 1989. The amount would be distributed as follows:

$ in billions

FY 1985	FY 1986	FY 1987	FY 1988	FY 1989
5.1	15.0	26.9	40.9	56.1

PUBLIC DEBT

Senator Hatfield:

What is your best estimate of the date on which the $1 trillion $490 billion public debt limit will be reached?

How long will it take to exceed the $2 trillion mark?

Secretary Regan:

Treasury's best estimate of the date on which the $1,490 billion public debt limit will be reached is April 1984. The precise date will depend on the actual flow of Government expenditures and receipts, including borrowings, between now and April. Based on the present and foreseeable patterns of these cash flows it is very unlikely that there will be a need for a debt limit increase before April.

The debt subject to limit will exceed $2 trillion in the fiscal year 1986, based on the February 1984 Budget estimates. The debt subject to limit is estimated at $1,824.7 billion on September 30, 1985 and $2,063.4 billion on September 30, 1986.

Senator Hatfield: The trade deficit grew from $42.7 billion in 1972 to $69.4 billion in 1983, a 63 percent increase. Estimates for the trade deficit in 1984 range as high as $120 billion, a 73 percent increase over 1983. Haven't we exacerbated the trade deficit problem because we borrow instead of tax?

Secretary Regan: The U.S. trade deficit was $6.4 billion in 1972 and $60.6 billion (balance of payments basis) in 1983. The principal forces influencing the trade balance have been the two major increases in oil prices during the 1970s, the growth of the U.S. economy relative to other economies, debt problems leading to import cutbacks by major less-developed countries, and the value of the dollar relative to other currencies. Imports of petroleum and petroleum products were $4.7 billion in 1972 and reached a peak of $79.3 billion in 1980 before declining to $53.8 billion in 1983. The lead position of the United States in world recovery, LDC debt problems, and the strength of the dollar were important influences on the 1983 trade balance. There is no simple, direct connection between fiscal policies and trade deficits. It is true that if tax rates were higher, U.S. economic growth and employment would probably be lower and our imports thereby would be lessened.

100 BILLION DOLLAR DOWN PAYMENT

Senator Hatfield: The President has proposed a 100 billion dollar down payment on the deficit. To the best of your knowledge:

1) Are reductions from the President's defense negotiable?

2) Are tax law changes negotiable?

3) Are entitlement changes negotiable?

4) Are discretionary programs negotiable?

Secretary Regan: To the best of my knowledge, all of the above items are negotiable. It is clear, however, that sweeping changes in any of the areas are likely to encounter serious practical difficulties in an election year. Therefore, we would like to see the down payment consist of some of the less contentious spending cuts still pending before the Congress, combined with certain measures to close tax loopholes and additional outlay savings based on the Grace Commission recommendations.

Senator DeConcini:

TREASURY SECRETARY REGAN: Customs Funding for Drug Interdiction

Secretary Regan, the Customs Service air program and the Coast Guard are the front line agencies in the Vice President's drug interdiction effort. Yet the 1985 budget calls for virtually dismantling the Customs air program and sharply reducing the acquisition construction, and improvement account at Coast Guard (the major drug interdiction account).

As I understand it, OMB recommended a small cut in the air program ($2.2 million) but that you recommended that major part of the 45 percent cut in the Customs air program.

It appears that the President is beefing up our investigative law enforcement agencies--FBI, DEA--while virtually giving up on the important drug interdiction effort that both the Vice President and the Congress have supported.

Q. How do you reconcile the drastic cutbacks in the Customs air program in your own Department with the President and Vice President's public support for a major national drug interdiction effort?

Secretary Regan:

Senator DeConcini, what I am proposing is that $11 million of the cost of operation and maintenance of the Customs air drug interdiction program, be assumed by the Department of Defense.

The terms of our aircraft loan agreements with the DOD requires that aircraft loaned to Customs by Defense be maintained at a high rate of readiness and in accordance with DOD standards.

My office in reviewing the program believes that the transfer of these services and costs to DOD will produce a more efficient and economical means of operating the aircraft. We believe it is more efficient than Customs attempting to duplicate the expert logistical support systems already in place at DOD.

I have requested this assistance from DOD because of the long standing cooperation DOD and Treasury have shared in this effort and in support of the Presidents' drug interdiction effort.

OFFICE OF THE SECRETARY -- INCREASE REQUESTED

Senator DeConcini:

Secretary Regan, I can't pass up the opportunity to

ask you about one account in the FY 1985 budget that will receive a larger percentage increase than defense, law enforcement, foreign aid or any other program that I know of.

I am talking about the Office of the Secretary account at Treasury.

You are asking for a 28 percent increase in your Office of the Secretary budget next year -- from $65,743,000 in FY 1984 to $84,242,000, an increase of $18.5 million. Now I know that part of that is for repair work at the Main Treasury Building, but even without these maintenance items, your office is targeted for a 13 percent boost -- about four times the current rate of inflation.

At a time when you are publicly making the case for fiscal restraint instead of tax increases, how can you justify an increase of this magnitude when every other agency is being asked to hold the line?

Secretary Regan:

The increase from FY 1984 to FY 1985 is made up of several items, all of which we consider vital to the effective management of the Office of the Secretary and the Department.

First, we have adjusted the FY 1984 amount of $65,743,000 by $3.9 million for inflationary cost increases ($2.5 million) and pay increases ($1.4 million). These amounts are required for the Office of the Secretary to provide the same level of services in FY 1985 as in FY 1984.

In addition, we have requested several program increases which are necessary to continue and enhance the trend of previous requests for the Office of the Secretary: an emphasis upon improved technological capability, coupled with level or reduced staffing levels. These increases include:

- o $5.7 million to renovate the Treasury Annex Building. This building, constructed in 1919, is in need of modernization in the next few years. A proposed move by the Bureau of Government Financial Operations will provide us the ideal opportunity to renovate the building while it is unoccupied.

- o $5.4 million for an enhanced Telecommunications Operations Center in the Main Treasury Building. These funds will support telecommunications center renovations, improved equipment and support facilities and the conversion from a Centrex to a digital telephone system. This project is important for reasons of security and will support the entire Department.

- o $3.4 million for ADP related improvements necessary to continue the Office of the Secretary's efforts to proceed with office automation in order to perform increasing workloads, and improve office productivity. Of this amount, $2.4 million is required to replace or upgrade the Office of the Secretary's (OS) mainframe computer which performs the major portion of the OS's ADP activities, particularly in the area of econometric and statistical modeling. The current mainframe equipment is rapidly approaching obsolescence and soon will not be able to accommodate the increasing user and workload requirements placed upon it. The upgraded or new equipment requested will accommodate more users, increase the size of models possible and reduce processing time. The remainder of the ADP request will support continued office automation enhancements required to increase office productivity.

This, in essence, is the FY 1985 Office of the Secretary's budget request. I realize that at first glance the increase requested appears to be substantial; however, as I think I have explained, I believe that all of the components of this increase are both necessary and defensible to enable Treasury to continue the improvements we are achieving.

As you can see, the Office of the Secretary is not just my immediate staff. Rather, it is comprised of many of the major offices of the Department, including the Assistant Secretaries for Economic Affairs, Tax Policy, International Affairs, Administration and the like.

QUESTIONS SUBMITTED TO MR. STOCKMAN

Future Space Science Funding

Question

Many are concerned that the proposed Space Station development will drain scarce funds away from important space science and applications programs. These concerns were echoed earlier when the Space Shuttle development program was "gobbling up" every space dollar available. What assurances can you give that the Administration will continue funding these programs at an enhanced level while the Space Station is being developed?

Answer

We do not believe the Shuttle "gobbled-up" every space dollar available or that the proposed Space Station necessarily threatens the continued maintenance of an enhanced level of basic and applied space science research.

With respect to the Shuttle development, an internal NASA study completed in 1983 and updated in 1984 concluded that "..there is no clear long-run correlation between the funding for [Office of Space Science and Applications] programs and the manned space programs". The report also indicated that: "Budget levels have remained in the $1 billion per year range [constant 1982 dollars] for OSSA, indicating that the Federal Government has maintained a consistent commitment to space science and applications over a long period of time..."

For the future, the budget outyear projections have been structured to accommodate both the programs proposed for 1985 and and a significant level of future new activities in areas other than the Space Station program. Specifically:

- o The 1985 budget's outyear projections include an overall 1% annual real growth increase in funding through 1989. As on-going commitments are completed, this would allow more than $3 billion during the period for future new activities other than the Space Station.

- o The proposed initial operating date and funding schedule for the Space Station program have been set so as to allow for a level of program uncertainties customarily expected in programs of this type. This flexibility helps to assure that the program can be continued within projected resource requirements. In addition, a thorough program definition effort is proposed to help reduce risks and uncertainties during the development phase of the program.

Thus, we are convinced that the Administration's space program will allow for continuing basic and applied space science research at an enhanced level if the intended flexibility in the conduct of the Space Station program is maintained.

Veterans Jobs Training Program

Question

What happened between the President's glowing support for this program before the American Legion convention last year and his zero budget request for the program in fiscal year 1985?

Answer

The Veterans Jobs Training program was enacted by the Congress and endorsed by the Administration as an additional approach to the solution of unemployment brought about by the recession and displacement of workers from some industries undergoing basic structural changes. The unemployment rate for Vietnam Veterans declined from 11.4% in January, 1983, to 7.7% in January, 1984, as the economic recovery took hold. Our forecasts now indicate that

unemployment rates will fall by another 2% by 1985, making this program unnecessary.

Our second reason for not seeking 1985 funding is that we are not yet sure how well the program will work. You point out that 40,000 veterans were certified in the first 2 months of the program. In fact, by February, 1984, there were more than 68,000 veterans certified to be eligible for the program. However, only 3,153 prospective employers had been certified for a total of 6,656 jobs. At an average cost to VA of $5,100 per job, if all these jobs were filled, the cost would be less than $34 million of the $130 million available. I should point out that, at this time, only 415 veterans are actually in jobs under this program. In light of these facts, we believe that the funds available will be sufficient for the two year period the program is authorized to operate; and that, in view of low employer participation, the program may give false hopes to many veterans.

Question

The Grace Commission also advocated cutting civil service and military retirement back to private-sector levels. Is this recommendation reflected in the 1985 budget? If not, why not?

Answer

The 1985 Budget states that the Administration continues its strong support of the civil service retirement reforms proposed in the 1984 budget. Those reforms are designed to bring civil service retirement costs more into line with those experienced by progressive private sector companies. The Grace Commission recommendations are also premised on this same objective. In 1985, the Administration will focus its legislative effort on three proposals: cost-of-living adjustment reform, a high 5-year salary average for the benefit formula, and increased agency and employee retirement contributions. The remaining reforms are reserved for consideration next year in conjunction with consideration of other large structural reforms in major budget components that are needed to bring spending and revenues back into alignment.

The Department of Defense, through the Fifth Quadrennial Review of Military Compensation (QRMC) has completed an analysis of the military retirement system. Several alternatives to the current system are being evaluated by the Services and Joint Chiefs of Staff that would reduce the costs to the taxpayer while permitting the Services to achieve levels of readiness that equal or exceed those provided by the current system. It is important to emphasize that changes to the retirement system will have a major effect on the retention of experienced career members and the QRMC has attempted to ensure that any recommended changes to the system will take into account the effects on retention and readiness.

While the Fifth QRMC did not complete its study in time to include recommendations in the FY 1985 budget, its report will be issued to Congress later in the year. The Administration will consider the recommendations of the Fifth QRMC, including the submission of legislation, as appropriate.

EPA Percent Increase

Question

On page 5-48 of the same document, it states that budget authority in 1985 for regulatory, enforcement, and research programs is 8% higher than in 1984. However, a press release issued by EPA (26 January 1984), providing background for the President's State of the Union address, stated that the same budget had increased by 27%. Why were these two different figures used?

Answer

The two figures compare the President's FY'85 budget request from two different baselines. The background information provided by EPA clearly indicated that the increases were compared to the original (January) FY'84 budget request. The 8% increase noted in the President's Budget compares the FY'85 budget request to the President's amended (June) FY'84 request. The amended level was enacted by Congress.

The purpose of EPA's comparison was to show the major increase in resources since Administrator Ruckelshaus arrived at EPA.

Shipment of Household Goods to Alaska

Question

The Grace Commission also advocated ending the prohibition on competitive bidding in the movement of military employees' household goods to/from Alaska and Hawaii. Is this recommendation reflected in the 1985 budget? If not, why not?

Answer

In 1979 and each year thereafter, restrictive legislation has been passed that specifically precluded including Alaska and Hawaii in a competitive rate procurement program. In view of this prohibition, the 1985 budget does not reflect this Grace Commission recommendation.

Defense -- Real Growth

Question

Mr. Director, will you please state or submit for the record your estimates for each year, 1980 through 1989, of the real growth in budget authority and outlays in both the DOD budget and in the national defense function.

Answer

% Real Growth

DOD-Military	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Budget Authority	2.1	12.5	12.1	7.5	3.7	13.0	9.2	3.5	3.8	3.9
Outlays	3.0	4.7	7.8	7.1	8.8	9.3	8.4	7.0	4.1	3.3
National Defense Function										
Budget Authority	2.1	12.5	12.1	7.8	3.8	13.0	9.3	3.4	3.6	3.7
Outlays	2.5	4.7	7.2	7.3	9.3	9.4	8.2	6.9	4.0	3.2

Defense -- Impact on the Economy

Question

What is your assessment of the long-term impact of defense spending on the economy, unemployment, interest rates and the economy in general?

Answer

First, defense spending should be undertaken only for purposes of national security, and not for economic purposes. It is the threat to the national security that determines the defense requirement, and it is on that basis that this budget has been prepared. Nevertheless, in considering the defense budget, it is important to understand the economic effect of that budget because that effect is an element of the nation's cost.

There has been much discussion about whether the U.S. economy can support the Administration's planned defense buildup without creating bottlenecks in major industries. However, in-depth analysis of defense industrial capacity by the Department of Commerce, with the cooperation of the Department of Defense, has concluded that domestic capacity is generally adequate to supply projected defense and non-defense needs.

On the question of interest rates and overall economic effects, such as inflation, we believe that if the Fed follows a steady policy of restraining the growth in money supply, inflation should remain under control and we should not experience negative economic effects. Inflation is a monetary phenomenon and interest rates are affected by the rate of inflation.

While the purpose of defense budgets is to provide for our nation's security, defense spending also has effects on output and employment. On the issue of the employment impact of defense spending, economic analysis and theory suggest that the employment effects of defense and non-defense spending are comparable.

Defense -- Year End Spending

Question

In what many people called the worst display of budget accountability, the Department of Defense obligated nearly $15 billion, on the last day of fiscal year 1983. Does the OMB authorize these obligations? Were you personally aware that approximately 5% of the entire Defense budget was being spent in a single day (5 of 250 billion)? What have you done or recommended to make sure this never happens again?

Answer

The Defense Department summarizes obligations on a monthly basis rather than on a daily basis. For the month of September 1983, Defense obligated $33.3 billion or 9% of 1983 obligations. Since 1980, 1981, and 1982 September obligations were between 11% and 12% of yearly obligations, I am not concerned about the 9% rate of September 1983 obligations. In addition, the General Provisions of the Defense Appropriation Bill restrict obligations to no more than 20% during the last two months of a fiscal year for annual appropriation. Obligations in the last two months of 1983 were 17.9%, within the 20% limit.

Defense -- Cuts

Question

Mr. Stockman, it is not a big mystery that earlier this year you recommended a more austere budget growth for the Department of Defense than what was actually proposed to the Congress.

In what areas of the Defense budget were you most concerned? Strategic weapons vs. conventional forces? New production vs. spare parts and maintenance? Cost-overruns? What were your specific recommendations?

Answer

Substantial reductions in the Defense program have already been made. During the fall budget review $16.6B in budget authority was reduced from FY 1985. Of the amount, $4.4B was due to lower inflation with the remainder coming from program reductions. In making these reductions, every effort was made to protect readiness improvement and essential modernization of both general purpose and strategic forces.

Indexing

Question

If by some chance Congress and the President decided to repeal or defer tax indexing, what would be the revenue increase to the Treasury annually between 1985 and 1989?

Answer

The estimated revenue increases resulting from the repeal or deferral of indexing are shown in the following table.

ESTIMATED EFFECT OF CHANGES IN TAX INDEXING
ON FISCAL YEAR RECEIPTS
(in billions of dollars)

	1985	1986	1987	1988	1989
Repeal.....	5.1	14.4	25.4	38.5	52.9
2 year deferral.....	5.1	14.4	18.8	21.7	24.7
1 year deferral.....	5.1	8.0	9.2	10.7	12.1

Savings Achieved

Question

Mr. Director, in his State of the Union address, the President mentioned that we had already achieved 300 billion dollars in budget savings for the period 1982 through 1986.

Of that amount, how much of the savings were achieved in appropriated discretionary domestic spending?

Answer

Including off-budget savings, the Administration and the Congress have achieved an estimated savings of $318 billion from 1982 through 1986 for domestic programmatic spending. Excluding social insurance programs (e.g., social security, medicare, and others), low-income benefits (e.g., medicaid, AFDC, and others), farm price supports and guaranteed student loans, which are the major items that are not appropriated, the savings were $183 billion from 1982 through 1986, or 57% of the total.

Public Debt

Question

What is your best estimate of the date on which the $1,490 billion public debt limit will be reached? How long will it take to exceed the $2 trillion mark?

Answer

Treasury's best estimate of the date on which the $1,490 billion debt limit will be reached is April 1984. The exact date will depend on the actual flow of Government outlays and receipts, and other cash flows including borrowing, between now and April. Based on the present and foreseeable patterns of these cash flows, it is very unlikely that there will be a need for a debt limit increase before April.

The debt subject to limit will exceed $2 trillion in fiscal year 1986 according to the February 1984 budget estimates. Debt subject to limit is estimated to be $1,825 billion on September 30, 1985, and $2,063 billion on September 30, 1986.

100 BILLION DOLLAR DOWNPAYMENT

Question

The President has proposed a 100 billion dollar down-payment on the deficit. To the best of your knowledge:

1) Are reductions from the President's defense negotiatable?

2) Are tax law changes negotiable?

3) Are entitlement changes negotiable?

4) Are discretionary program negotiable?

Answer

In his FY 1985 Budget, the President has put forward proposals that have modified Administration policy in all four of these areas. Certainly, decisions about each of these areas of potential deficit reduction will need to be made if a broadly supportable consensus is to be achieved.

LINE-ITEM VETO

Question

Let us assume that the line-item veto had been in place last year. After the adjournment, the President uses his line-item authority to veto spending for EDA, postal service subsidies, and the Legal Services Corporation. On the first available vehicle after reconvening, the Congress passes a supplemental bill that provides funding for these three programs and rescinds the recently enacted IMF funding authority.

The President then has the option to use his veto authority or line-item veto authority. By having a line-item veto power, in this hypothetical situation, has the President enhanced or diminished his ability to enact his spending priorities?

Answer

The question assumes a degree of surprise, one-upsmanship, and confrontation that is not likely

to occur in practice. The President's position will be made clear at every step of the way, so the actions he takes after a bill is passed will not come as a surprise to the Congress.

The President's ability to enact his spending priorities--or, better, to reduce the budget deficit--will not be diminished even in the hypothetical situation described in the question. Situations similar to the one described occur under present law.

Question

Mr. Director, if the President had had line-item veto authority last year, what specific programs would you have recommended for veto in our appropriation bills?

By how much would that have reduced the $184 billion deficit you predict in 1984?

Answer

The specific applications of line-item veto authority will depend upon the nature of the authority that is granted and the conditions that prevail at the time decisions are made. Not knowing what authority the Congress might have granted, it would be fruitless to speculate on how such authority might have been used last year. Nor is it possible to replicate the conditions under which the authority might have been used.

Question

Will you ask that the Administration's proposal for a line-item veto apply to tariff, revenue, entitlements, and other authorizing measures as well as to appropriation bills?

If not, don't certain revenue measures contribute to the deficit by reducing receipts? Don't certain entitlements increase outlays?

Answer

In his State of the Union message, the President drew analogies to the practices of State governments, forty-three of which have such Constitutional provisions as methods of appropriations control. No State, to my present knowledge, affords its Governor line item veto authority over revenue measures of any type; few have any authority to distinguish non-appropriations measures.

The exact configuration of any restructuring of the Presentment Clause will be determined, of course, by

the nature of a Constitutional amendment proposed by the Congress to the States. The ultimate scope of this new authority depends in significant measure on what the Congress is willing to propose.

Question

Last year, Congress cut a deal with the Administration. In return for the $8.5 billion in IMF funding that you wanted, we got a revised housing authorization bill.

What is the likelihood that the Administration would have gotten its $8.5 billion for IMF, if members thought the compromise package would be re-written downtown before being signed by the President?

Answer

In situations like that assumed in the question, the strong probability is that the Administration would have made absolutely clear what would be accepted and what would not. The Congress would not have been surprised by any action that the President would have taken after the bill had been passed.

Equity to the Elderly and Low Income

Question

Are we to interpret this year's "lenient" treatment of social programs as a short term phenomenon or do you genuinely believe that we have made all the cuts possible from programs for the elderly and low-income?

Social Security & Medicare have dropped from 15.1% of GNP in 1981 to 14.3% in current fiscal year and will fall further under current law to 12.6% of GNP by 1989.

Answer

The President's fiscal year 1985 budget, with legislative savings proposals for Supplemental Security Income, Aid to Families with Dependent Children, Food Stamps, Child Nutrition, and Medicare and Medicaid, builds on the major reforms already achieved in these programs through the 1981 Omnibus Budget Reconciliation Act and the Tax Equity and Fiscal Responsibility Act of 1982. These proposals are designed to enhance program efficiency and effectiveness; improve targetting of scarce resources on the needy; reduce erroneous payments, fraud and abuse; and encourage greater work efforts and self-support by those who should be expected to do

so. They do not halt the benefits of those who need them. Last year, the Administration worked together with Congress on a bipartisan solution to enact major reforms to restore solvency to the Old Age, Survivors and Disability Insurance (OASDI) trust funds.

Despite the major restructuring of Hospital Insurance enacted in the Social Security Amendments of 1983, added reforms are needed to assure the trust fund's continued solvency. The Social Security Advisory Council, which concentrated exclusively on the Medicare crisis, is scheduled to issue its final report in the near future. As Secretary Heckler has indicated, the Department of Health and Human Services will carefully assess the Advisory Council's report and recommendations in developing solutions to assure the solvency of this vital insurance program.

It should be noted that OASDI and Medicare will grow by $20 billion in fiscal year 1985, an increase of 8.4% over the fiscal year 1984 level of spending for these programs.

Grace Commission

Question

In his statement on January 16, 1984, President Reagan called the Grace Commission Report a "great achievement" and stated that "we'll work with the departments and with the Congress to implement them."

Were the recommendations of the Grace Commission included in the 1985 budget? If they were implemented in part, how much higher would the 1985 deficit have been had they not been implemented?

Answer

Some recommendations of the President's Private Sector Survey on Cost Control (PPSSCC) were included in the 1985 Budget. Examples are:

Item	PPSSCC 3-year savings estimates ($ in millions)
Reduce Government-owned contractor operated (GOCO) micromanagement, DOE	495.0
Complete A-76 reviews, DOE	59.4
Improve use of ADP resources, DOE	29.7
Use IG resources more effectively, DOE	72.6
Consolidate and reorganize personnel operations, HHS	212.8

Reduce the GS-11 to GS-15 bulge, Government-wide	4790.1
Eliminate redundant functions and staff throughout the Public Health Service, HHS	474.0
Discontinue purchase of foreclosed loans, VA.	225.0
Consolidate ADP of UMTA, MARAD, FRA, NHTSA, RSPA, TCC in the Department of Transportation	46.4
Reduce INS overhead, DOJ	26.2
Close seventeen travel offices throughout the government	586.8

An all-inclusive listing is not available, because the Administration began carrying out management improvements some time ago. While PPSSCC members were very helpful in discussing and planning these efforts there is overlap that is hard to distinguish. Some of these savings have been reflected in the 1984 Budget transmitted in January 1983 and others are reflected in the 1985 Budget. Many more are being examined and will be considered for future implementation The review process is by no means complete. For an explanation of the process, refer to the answer to the next question.

Question

In his State of the Union message, the President mentioned that the Grace Commission had made over 2,500 recommendations on how the budget should be cut. He also stated that these recommendations "are being examined throughout the Administration." Where this examination has been completed between the Office of Management and Budget and the agency, please provide a list for each agency of which recommendations have been adopted and which were rejected in the 1985 budget.

Answer

The President's Private Sector Survey on Cost Control (PPSSCC) has released 47 separate reports including a summary report that was presented to the President on January 16, 1984. The status of the Administration's review is that the affected agencies, the White House Office of Policy Development, and OMB have been evaluating the PPSSCC reports in a coordinated review being managed by the White House Office of Cabinet Affairs (OCA). Thus far, initial reviews of 14 of the reports have been completed, and the Administration's recommendations on the reports are in various stages of revision, adjustment, and implementation. Examples of recommendations included in the 1985 Budget were provided in reply to the previous question.

Question

Based on your experience as Director of the Office of Management and Budget, do you believe that "waste in the Federal government amounts to at least $424 billion over three years..."?

Answer

Undoubtedly, significant budget reductions can be achieved over a three-year period if the Congress and the Administration can reach agreement to do so. Any savings of the magnitude suggested by the Grace Commission would, however, have to come from reductions in programs as well as from elimination of waste. Clearly, the Commission's figure includes savings from both sources.

For at least two reasons, even if all of the Grace Commission recommendations were accepted immediately, they would not reduce the fiscal year 1985-87 deficits by $424 billion.

- Some of the savings proposed by the Commission were included in the 1985 Budget.
- As Mr. Grace acknowledged when testifying before the Senate Finance Committee, some of the assumed savings will not be realized fully until well after that period.

Foreign Aid -- Low Interest Loans

Question

It has recently come to my attention that the Department of State will begin offering low interest, 5 percent, loans to foreign governments for the purpose of acquiring military hardware from the U.S.

What is the usual and accustomed interest rate charged for such borrowing?

What criteria is used to determine the countries that will receive preferential treatment?

What are the net revenue losses due to the discounted interest rate when compared to the usual interest rate of 11 percent.

What affect will this change have on the outlays of the Guarantee Reserve Fund in FY85 and beyond.

To the best of your knowledge will the program be limited to military purchases or will such low interest loans also be available for economic assistance as well?

Answer

Since the concessional Foreign Military Sales Credit (FMSCR) program is a new proposal, there are no "usual" or "accustomed" interest rates for purposes of comparison. The principal criterion used to select recipient countries will be economic need.

Since it is planned that the concessional loan program will be administered in roughly the same fashion as the present FMSCR loan programmed, net revenue losses will be determined on the

basis of the interest rate differential. For example, a $500 million concessional FMSCR program at 5 percent would cost the United States $30 million per year if the cost of money to the U.S. Treasury is 11 percent. If the cost of money to the Treasury grew to 15 percent, the forgone U.S. interest for a $500 million program would total $50 million.

If the Administration's proposal is adopted, there will be no new demands on the GRF resulting from new FMSCR appropriations since the GRF applies only to guaranteed loans.

Yes, the program will be limited to military purchases. Low interest loans are already available for economic assistance programs. The Economic Support Fund, for example, offers 3 percent and 5 percent loans to a number of countries.

Additional Supplementals

Question

Mr. Director, when are we likely to receive from the Administration a supplemental request to implement the findings of the Kissinger Commission on Central America?

What is your best estimate of the cost of that supplemental?

Do you anticipate any additional supplemental requests, not included in the budget, for fiscal year 1984?

Answer

The Administration will send a supplemental request for FY 1984 and a series of budget amendments for FY 1985 to implement the findings of the National Bipartisan Commission on Central America by the time the Congress returns from the Presidents' Birthdays recess.

The package in effect replaces the proposed Assistance to Central America account for FY 1984 and FY 1985. The FY 1984 supplemental requests for all accounts total $659 million.

The Administration has already transmitted an additional supplemental request for PL-480 for Africa. As circumstances warrant, other needs may arise that would require additional budgetary resources. The Administration will keep the Committee informed of any new requirements that may develop.

DOMESTIC SPENDING

Question

On page 3-3 of The Budget of the United States - FY 1985, it states: "Non-entitlement domestic outlays have been cut 24% in real terms..." In light of the fact that these are the funds controlled by the

Appropriations Committee, would you agree that the Appropriations Committee has cooperated with the Administration's "success in achieving domestic spending control..."?

Answer

The Appropriations Committees in both the House and the Senate have generally cooperated with the Administration in imposing spending restraint on non-entitlement domestic programs. Nevertheless, we cannot rest on this record of success. We must continue to hold the line against unwarranted increases in those programs.

EPA INCREASE

Question

As background for evaluating President Reagan's statement that "though this is a time of budget constraints, I have requested for EPA one of the largest percentage budget increases of any agency," please provide a list of those agencies whose increases were larger or smaller.

Answer

Overall, the EPA budget increased by 7.4%. However, excluding constant funding for construction grants, the increase is 18.8%. No other domestic department or major independent agency received as large an increase for discretionary annually funded programs. Examples of major agencies with increasing budgets include the Departments of Transportation, Energy, and Justice and NASA and the Veterans Administration.

Power Marketing Subsidies

Question

A number of the recomendations in the Grace Commission report have been public for many months. For example, in its press release, the Commission advocates ending subsidies in electricity marketing in the northwest. Has the Administration proposed ending these subsidies in its 1985 budget? If not, why not?

Answer

Despite major progress in eliminating or reducing special interest economic subsidies over the past three budget rounds, substantial opportunities for savings still exist, as the Grace Commission studies suggest. The major obstacles to achieving these savings are the natural, parochial political pressures

to retain previously granted advantages, and the more compelling argument advanced by individual interest groups that subsidies should be eliminated across-the-board or not at all.

Fashioning a consistent set of federal policy standards against which to assess local, regional and industrial sector subsidies would be a difficult and demanding task. Yet an even-handed set of criteria fairly applied could produce billions in annual budget savings. A policy framework based on user fee principles and national vs. purely local or sectoral economic benefits could be expected to reduce outlays significantly in a number of areas. These include not only debt repayment and interest charges on the unpaid Federal power generation and transmission investment but also such areas as:

- o capital and maintenance costs for inland waterways;
- o operating costs of the FAA air traffic control system;
- o search and rescue, inspection and licensing costs of the Coast Guard;
- o capital and maintenance costs of deep ports;
- o large interest subsidies to rural electric and telephone cooperatives;
- o operating subsidies for local mass transit systems and maritime operators;
- o subsidized insurance premiums offered by the Pension Benefit Guarantee Corporation and many other federal insurance agencies;
- o inadequate user fees for a variety of federal commercial inspection, liscensing and information services offered by USDA, Commerce, HUD, Treasury and many of the regulatory agencies;
- o charges and fees for user of federal lands, parks and other facilities;
- o subsidies for local economic development which merely shift the geographic location of investment and development such as those offered by EDA, HUD, Farmer's Home Administration, Corps of Engineers, and through such tax code features as industrial development bonds.

This partial list of remaining unwarranted economic subsidies provides ample evidence that potential savings of billions per year are possible, if an acceptable policy framework for subsidy phase-out can

be developed and intense special interest pressures overcome. Most of these have been previously proposed by the Administration, but not in the context of a comprehensive policy framework.

Because many of these proposals have been repeatedly rejected by individual congressional committees, the Administration has decided not to propose them again at this time. Nevertheless, we believe that there is an overriding requirement for structural budget reform to bring future spending and revenues into alignment at an acceptable share of GNP. Consequently, we believe that a more effective strategy is to introduce a comprehensive program to root out unjustified economic subsidies in the next budget round.

Questions Submitted to Chairman Feldstein

DEFENSE -- IMPACT ON THE ECONOMY

Q: Many economists and financial analysts have commented that the 82% increase in defense spending since 1980 ($144 billion to $264) may act as a short-term stimulus to financial markets but that deleterious long-term impacts may occur as a result of concentrating such enormous resources into such a narrow industrial base.

What is your assessment of the long-term impact of defense spending on the economy, unemployment, interest rates and the economy in general?

A: I do not think that defense spending is different from other types of government spending in terms of its effects on the economy. Furthermore, our economy can clearly support the levels of defense spending called for in the administration's budget.

The appropriate measure of the burden of defense spending places on the economy is its share of GNP. This measure avoids inflationary distortions and takes into account the ability of the economy to support the spending. In 1960, defense absorbed 9.7 percent of GNP. In 1970, 8.4 percent. The Administration's call for a 7.0 percent share in 1985 and a 7.6 percent share in 1989 is thus not excessive by historical standards and is of a size that the economy can support.

TRADE DEFICIT

Q: The trade deficit grew from $42.7 billion in 1972 to $69.4 billion in 1983, a 63 percent increase. Estimates for the trade deficit in 1984 range as high as $120 billion, a 73% increase over 1983. Haven't we exacerbated the trade deficit problem because we borrow instead of tax?

A: There is no question that the trade deficit is in large part a response to Federal borrowing. Government borrowing competes with private borrowers for the pool of available savings, driving up the interest rate. This high interest rate attracts capital from abroad. This foreign capital inflow results in increased demand for the dollar, driving its value up relative to other currencies. The higher valued dollar makes imports cheaper and American exports more expenseive, causing a trade deficit.

PUBLIC DEBT

Q: What is your best estimate of the date on which the $1 trillion $490 billion public debt limit will be reached?

How long will it take to exceed the $2 trillion mark?

A: Treasury's best estimate is that the $1,490 billion public debt limit will be reached in April. The date at which the Federal debt will exceed $2 billion depends on what budget is adopted. According to the Administration's budget the $2 trillion mark would be exceeded by the end of FY 1986.

REVENUES

Q: Dr. Feldstein, I doubt that there has ever been a President or Member of Congress who liked to raise taxes. We all can think of good political reasons for not raising them, especially in an election year. This budget includes massive deficits for this year and future fiscal years.

All revenues collected in FY 1989 will not be sufficient to cover the costs of the President's buildup in defense and international affairs; social security and medicare; income security and veterans programs; and interest costs on the debt.

There would be a deficit even if you exclude funding for the rest of the government, including activities such as: all of the Forest Service; all of EPA, all of the CCC; all of the Departments of Transportation, Education, Interior, Justice, Commerce; and all of NASA.

My question to you is "what good economic reasons are there for ignoring in this budget submission the obvious revenue shortfall problem?"

A: There is, of course, no good reason for ignoring the budget deficit problem. That is why we in the Administration feel so strongly about the need to come up with a signficant "down payment" on the deficit this year, while making it clear that these deficits would be reduced further in the out years through future action.

QUESTIONS FOR DR. FELDSTEIN FROM SENATOR PATRICK LEAHY

Q1: The President has often stated that the present strong recovery indicates the soundness of his economic policies. On page 6, you state that, "if such deficit reductions are not enacted, the interest rates are not likely to fall over the next five years as we have projected and growth of real GNP is likely to be slower than we have assumed." If the present high interest rates have not prevented the strong recovery of a very weak economy why will similar high interest rates slow GNP growth in the future?

A: The present high rates have obviously not prevented the recovery. In fact the depth of the recession and the resulting excess capacity have meant that the direct fiscal stimulus of the 1983 and 1984 deficits has done more to raise demand than the increased real interest rate has done to depress demand.

Nonetheless, the current high real interest rate, caused not by the 1984 deficit but by the string of large deficits projected through the end of the decade, is already having a pronounced effect on the recovery. Even though the pace of the recovery may not have been slowed, the composition of output has changed. The most conspicuous example is the sharp decline in net exports. High interest rates in the United States attract funds from the rest of the world, causing the exchange value of the dollar to rise. The strong dollar makes it difficult for U.S. products to compete in world markets and makes foreign products more attractive to American buyers. In addition, the high real interest rate is no doubt also causing the demand for housing, for consumer durables, and for plant and equipment investment to be lower now than it would otherwise have been.

If the deficits and high interest rates persist, the crowding out would also persist but the pattern of crowding out would change over time, in ways threatening to the recovery. As the value of the dollar declines, the merchandise trade deficit is likely to shrink, focusing more of the crowding out on the domestic capital market. The current rise in profits and retained earnings that result from the cyclical upturn and from the 1981 tax changes temporarily protects business investment and concentrates more of the domestic crowding out on residential construction. This too will change with time, placing more of the burden of future crowding out on business investment in plant and equipment.

It is clear that the persistence of large structural budget deficits would contribute to producing a lopsided recovery. The recovery would not be shared fully by the export industries and by those firms that compete with imports from abroad. Nor would the construction industry and those industries that are directly involved in the production of capital goods and consumer durables be likely to keep pace with overall economic activity.

As a result, employment and economic activity would shift from these contracting interest-sensitive sectors to the areas of expanding demand in the services and nondurable goods indus-

tries and in the defense-related industries. If this shift of demand proceeds smoothly enough, the overall recovery would continue at a satisfactory pace with declining total unemployment. It is quite possible, however, that the additional demand would concentrate in sectors that are operating close to capacity while the crowding out withdraws demand from industries where a great deal of excess capacity exists. If so, much of the additional demand might be absorbed in price increases while the crowding out adds to unemployment. If this occurs, the resulting recovery would be slower paced, more fragile, and more inflationary than a more balanced recovery.

The longer term prospects for growth are perhaps even more closely related to the deficits. The increased output associated with the early phase of the recovery comes primarily from an increased rate of capacity utilization and employment. However, over the longer term, as capacity becomes more fully utilized and unemployment falls, the growth rate of the economy is determined in large part by the rate of capital formation. High interest rates shift output from investment to consumption as the deficits absorb a large fraction of the funds otherwise available for investment. Thus, the Nation's rate of investment is lowered from what it would otherwise have been, and long term growth prospects are seriously reduced.

Q2: If high interest rates will slow growth in the future, do you believe the tight-money policies of the Federal Reserve, which were endorsed by the President, were a major cause of the recent recession?

A: The recent recession was a product of the inflationary policies of the late 1970s. The inflationary momentum of that period had been broken, and the Fed has enunciated a policy of maintaining money supply growth consistent with strong real growth and gradually falling rates of inflation. The current high real interest rates are not the product of this policy, and any attempt to lower interest rates through accelerated money growth would lead only to increased inflation.

Q3: On page 6 of your statement, you cite two dangers of continued deficits. They are higher interest rates and higher inflation. Since all concerned have ruled out further social security cuts, and the defense budget can only be marginally adjusted because of its forward funding, the only mechanism available for making major reductions in the deficit is a tax increase. Will not a tax increase reduce GNP by removing from the private sector funds they would have spent on goods and services?

A: Any decrease in the government deficit, whether through spending cuts or tax increases, removes funds from the private sector that would otherwise have been spent on consumption. However this decrease also frees funds for private investment that would otherwise have been borrowed by the government. Thus a decrease in the deficit will probably decrease consumption and increase investment. The overall effect on aggregate demand and GNP depends on the relative magnitudes of these two effects. Early in a recovery when capacity is under utilized

the overall effect is probably positive, but as the economy approaches full-employment this may no longer be the case, as I explained in answer to the first question. In any case the decrease in the deficit would shift output from consumption to investment, allowing for more capital stock formation and growth over the longer term.

Q4: Please explain in detail how high federal deficits will keep interest rates high.

A: Government borrowing is just one of competing uses to which saving can be put; others include investment in plant and equipment and in housing. A federal deficit of 5 percent of GNP would absorb about two-thirds of all the domestic saving. The reduced availability of investable funds means that the real rate of interest must rise until the demand for funds for private investment is reduced to the available supply. More generally, the real net-of-tax cost of capital must increase relative to the real net-of-tax return on capital until the demand for funds is reduced to the available supply.

There are other sources of investable funds: state and local government surpluses and foreign capital inflows. To the extent that funds from these sources, or from private domestic saving, were to increase the supply of saving, the interest rate would rise less and investment would fall less. Private saving and state and local government surplus have not responded to the increased demand for investable funds. Foreign capital inflows, however, have greatly increased in response to higher rates of interest, but only at the cost of equally large increases in our trade deficit. These inflows have undoubtedly kept the interest rate lower than it otherwise would have been. They are unlikely to continue indefinitely at the magnitude projected for 1984, however, and as they dry up increased pressure will be put on interest rates.

Q5: With regard to question four, please provide the best data available on what effect a one-third and a two-thirds reduction in the deficit would have on the level of interest rates.

A: Any precise answer to this question would not be completely honest. The exact magnitude of the response to a decreased deficit depends on a number of variables that are difficult to quantify. For example, it is very important that the reduction be seen as long lasting because market expectations of future deficits play a key role in determining the interest rate. Another area of uncertainty is the response of foreign investors. However, it is clear that a large reduction in the out-year deficits is the only way to lower real interest rates and promote the long-term health of the economy.

QUESTION FOR DR. FELDSTEIN FROM SENATOR DECONCINI

Q. The President in his State of the Union address, indicated that he was directing the Treasury Department to report back to him this coming December with suggestions for reforming and

simplifying the tax system. Specifically, what direction has been given to implement this directive?

Several tax simplification measures have been introduced. Two that have received a good deal of attention are my bill S.557, which creates a modified flat-rate tax system for both personal and corporate income tax, and the so-called Bradley-Gephardt bill which has several tiers of taxation, surcharges, and retains several of the present tax exclusions. Have you done any economic studies on either of these proposals that would show their impact on revenue raising, economic stimulation, and deficit reduction?

Studies done by Dr. Robert Hall and Dr. Alvin Rabushka of the Hoover Institute on the tax and economic impact of a bill such as mine indicate that had a proposal such as S.557 gone into effect in fiscal year 1983, that the total reduction in deficit by fiscal year 1987 would have been in excess of $100 billion dollars per year. For fiscal year 1984, the reduction would have been $50 billion; fiscal '85, $65 billion; fiscal '86, $83 billion.

A: The Treasury is studying many tax reform and simplification measures, and we are awaiting the results of their study. It would be premature for me to speculate now on specific proposals.

BUDGET ESTIMATES AND ASSUMPTIONS

Senator PROXMIRE. Mr. Chairman, could I ask one more question?

Chairman HATFIELD. Yes.

Senator PROXMIRE. Because I wasn't successful in stirring up any difference. Let me just try once more very quickly.

Secretary REGAN. Senator, do we have to go through this? [Laughter.]

Chairman HATFIELD. One last turn of the rack.

Senator PROXMIRE. Do the economic estimates and the budget before the Congress correspond with the economic assumptions underlying the budget? In other words, are the GNP, trade balance, inflation interest rates, et cetera, the same in both documents?

Mr. FELDSTEIN. Yes.

Senator PROXMIRE. They are the same in——

Mr. FELDSTEIN. Yes.

Senator PROXMIRE. Then why was Mr. Secretary saying we could throw it away?

Secretary REGAN. That was last week. That was last week. [Laughter.]

Senator PROXMIRE. All right.

SUBCOMMITTEE RECESS

Chairman HATFIELD. I want to thank each one of you gentlemen for your time here today, Mr. Secretary, Mr. Chairman, Mr. Director. The meeting is adjourned.

Secretary REGAN. Thank you.

Senator STENNIS. I want to commend these gentlemen, and thank them, too. They have rendered enough service. I know enough about the service, but you are rendering a greater service, all of you.

Chairman HATFIELD. Thank you, Senator from Mississippi.

[Whereupon, at 3:48 p.m., Wednesday, February 8, the committee was recessed, to reconvene at the call of the Chair.]

ECONOMIC OVERVIEW FOR FISCAL YEAR 1985

WEDNESDAY, FEBRUARY 22, 1984

U.S. SENATE,
COMMITTEE ON APPROPRIATIONS,
Washington, D.C.

The committee met at 9:44 a.m., in room SD–192, Dirksen Senate Office Building, Hon. Mark O. Hatfield (chairman) presiding.

Present: Senators Hatfield, Stevens, Abdnor, Kasten, Mattingly, Rudman, Specter, Stennis, Inouye and Bumpers.

CONGRESSIONAL BUDGET OFFICE

STATEMENT OF RUDOLPH G. PENNER, DIRECTOR

INTRODUCTION OF WITNESS

Chairman HATFIELD. The hearing will please come to order.

Today, as part of our fourth annual economic overview hearings, we will receive testimony from Dr. Rudolph G. Penner, Director of the Congressional Budget Office. As you know, the CBO provides this committee with an analysis of the President's budget submission which is the subject of this morning's hearing.

Dr. Penner, it is a pleasure to welcome you to our committee. This is your first appearance before this Committee as Director of the CBO. The Appropriations Committee and Congress have come to rely on the professional, nonpartisan assistance provided by your unheralded staff at CBO. We might not always like the hard, cold reality you present to us, but we appreciate the fact that the numbers and policy recommendations are prepared in an impartial manner by competent, dedicated professionals. Especially lately, we Members of Congress want to thank you for your leadership during these extraordinarily difficult and frustrating times.

Dr. Penner, I know that you have a prepared statement for the record. We will place it in the record in full, but would you please at this time briefly summarize your remarks so that we will have plenty of time for you to answer our many questions?

I am just happy to have you here.

CBO ANALYSIS OF PRESIDENT'S BUDGET

Dr. PENNER. Thank you very much, Mr. Chairman. Let me add to your praise of my staff, because they have been working extraordinary

hours this month and have done a wonderful job generally. They have managed to tire me out.

I am pleased to have this opportunity to appear this morning before the committee to present the Congressional Budget Office's analysis of the President's budget for the upcoming fiscal year. Copies of our analysis, which was prepared at the request of this committee, have been distributed to Members, and my statement this morning will summarize its findings.

The administration budget proposals for fiscal years 1985–89 as set forth in the February budget documents do not present major changes in current policy, either in terms of revenues or in terms of expenditures.

As a consequence, using our economic assumptions and estimating methods, CBO projects that the budget deficit under the administration's proposals would rise steadily during the next 5 years to nearly $250 billion by 1989. The difference between our estimates of the budgetary impact of the administration's proposals and those contained in the President's budget document can be attributed largely to different economic assumptions for 1986–89, particularly for interest rates.

CBO PROJECTIONS OF FUTURE DEFICITS

Under current policies, the Congressional Budget Office projects very large and growing deficits, rising from nearly $200 billion in 1985 to over $300 billion in 1989. As a percent of gross national product, the baseline deficits would decline from 5.3 percent in 1984 to 5 percent in 1985 but rise thereafter, reaching 5.7 percent in 1989.

The CBO baseline budget projections were presented in detail in our recent annual report to the Budget Committees and are summarized in table 1 of my prepared testimony.

TABLE 1. THE BUDGET OUTLOOK UNDER CURRENT POLICIES AND THE ADMINISTRATION'S 1985 BUDGET PROPOSALS (By fiscal year)

	1984	1985	1986	1987	1988	1989
	In Billions of Dollars					
CBO Baseline a/						
Revenues	663	733	795	863	945	1,016
Outlays	852	930	1,012	1,109	1,217	1,323
Deficit	189	197	217	245	272	308
Administration's Program as Estimated by CBO						
Revenues	665	741	807	878	964	1,039
Outlays	851	933	1,018	1,111	1,204	1,287
Deficit	186	192	211	233	241	248
	As a Percent of GNP					
CBO Baseline a/						
Revenues	18.6	18.7	18.7	18.7	19.0	18.9
Outlays	23.9	23.8	23.8	24.0	24.4	24.6
Deficit	5.3	5.0	5.1	5.3	5.5	5.7
Administration's Program as Estimated by CBO						
Revenues	18.7	19.0	19.0	19.0	19.3	19.3
Outlays	23.9	23.9	24.0	24.1	24.1	23.9
Deficit	5.2	4.9	5.0	5.1	4.8	4.6
Memorandum: Gross National Product (In billions of dollars)	3,563	3,910	4,251	4,612	4,987	5,379

a/ The CBO baseline figures are revisions of those appearing in Congressional Budget Office, Baseline Budget Projections for Fiscal Years 1985-1989 (February 1984).

TABLE 1

PRESIDENT'S BUDGET PROPOSALS

Dr. PENNER. The numbers shown in this table have been revised somewhat to reflect new information contained in the President's budget about spending programs and also to reflect revised assumptions about inflation in the defense sector.

The President's budget for 1985 proposes relatively modest increases in revenues and reductions in total spending from the levels projected by CBO under current policy. Proposed increases in defense spending would be offset more or less by reductions in nondefense spending. The administration's budgetary proposals would hold the deficit-to-GNP ratio at about 5 percent during the next 3 years and reduce it to 4.6 percent by 1989. Thus, deficits would remain very high by recent historical experience.

The deficit-to-GNP ratio for the 1980s as a whole would average 4.4 percent as compared to 0.4 percent in the 1950's, 0.8 percent in the 1960's, and 1.9 percent in the 1970's.

The administration's 1985 budget reflects basically the same priorities as its 1984 budget proposal, although the size of the proposed policy changes has been scaled back. Proposed tax increases are substantially smaller than last year, primarily because the administration is no longer proposing a contingent tax increase beginning in 1986. The administration's defense program is somewhat smaller than that proposed a year ago, although the requested funding levels are still greater than those included in the congressional budget targets last year. No new proposals are made for social security or railroad retirement, which were subject to major legislative reforms last year. Finally, the administration is no longer requesting or has reduced in size a number of cuts in entitlement programs and in nondefense discretionary spending that it has sought unsuccessfully in the past.

BUDGETARY EFFECT OF ADMINISTRATION PROPOSALS

The estimated budget effect of the administration's policy proposals would be to increase revenues by a total of $77 billion over the next 5 years and to reduce projected outlays by $38 billion relative to the levels in our baseline projections. The total deficit reduction for 1985–89 is estimated by CBO to be $115 billion, as shown in table 2.

TABLE 2. THE ADMINISTRATION'S DEFICIT REDUCTION PROPOSALS AS ESTIMATED BY CBO (By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	Cumulative Five-Year Total
CBO Baseline Deficit	197	217	245	272	308	1,239
Proposed Changes						
Revenues						
Taxation of Health Insurance Premiums	-4	-6	-8	-10	-12	-40
Other Tax Increases	-6	-10	-12	-14	-17	-59
Tax Reductions	2	4	5	5	5	22
Subtotal	-8	-12	-15	-18	-24	-77
Outlays						
National Defense	10	21	23	20	11	85
Entitlements and Other Mandatory Spending	-4	-6	-9	-12	-15	-46
Nondefense Discretionary Spending	-2	-5	-7	-12	-17	-44
Offsetting Receipts	*	-1	-2	-4	-6	-13
Net Interest	-1	-2	-3	-5	-10	-20
Subtotal	3	7	2	-13	-36	-38
Total Policy Changes	-5	-5	-13	-32	-60	-115
President's Budget as Estimated by CBO	192	211	233	241	248	1,124

TABLE 2

DEFICIT REDUCTIONS

Dr. PENNER. Most of this reduction occurs in 1988 and 1989 under our projections. For the next 3 years, which will be the period covered by the next congressional budget resolution, we estimate that the administration's budget proposals would reduce projected deficits by only $24 billion compared with the CBO baseline.

The administration shows a greater reduction from its current services levels, but that is because its current services projections include the cost of last year's defense proposals as estimated in the administration's 1984 mid-session review. CBO uses as a starting point the lower targets for defense budget authority contained in last year's budget resolution.

REESTIMATES OF AGGREGATES

My prepared testimony discusses in some detail the various spending and revenue proposals. I shall pass over that and go directly to our reestimates of the aggregates.

Our projections of the budget implications of the administration's proposals are significantly different from those contained in the President's February budget. We project that revenues will be slightly lower and outlays significantly higher, especially after 1986. As a consequence, we estimate that the administration's budget plan would result in rising deficits over the next 5 years instead of declining deficits. The bulk of the estimating differences result from different economic assumptions, especially for interest rates.

Table 3 compares the CBO and administration projections of the President's budget program and shows how much of the estimating differences can be attributed to economic assumptions and how much to technical estimating differences.

TABLE 3. CBO AND ADMINISTRATION ESTIMATES OF THE ADMINISTRATION'S BUDGET PROGRAM
(By fiscal year, in billions of dollars)

	1984	1985	1986	1987	1988	1989
Revenues						
Administration Estimate	670	745	815	888	978	1,060
CBO Estimate	665	741	807	878	964	1,039
Outlays						
Administration Estimate	854	925	992	1,068	1,130	1,184
CBO Estimate	851	933	1,018	1,111	1,204	1,287
Deficit						
Administration Estimate	184	180	177	180	152	123
CBO Estimate	186	192	211	233	241	248
Differences in Projections						
Revenues						
Economic	-1	-1	-2	-3	-6	-7
Technical	-4	-3	-6	-6	-9	-13
Total	-5	-4	-8	-10	-15	-21
Outlays						
Economic	2	8	17	32	59	87
Technical	-5	*	9	11	15	16
Total	-3	6	26	43	74	103
Deficit						
Economic	3	8	19	35	65	95
Technical	-1	3	15	17	24	30
Total	2	12	34	53	89	124

* Less than $500 million.

TABLE 3

ECONOMIC FORECASTS FOR 1984 AND 1985

Dr. PENNER. The CBO and administration economic forecasts for 1984 and 1985 are very similar. Projected growth rates for real GNP are almost identical. The administration's short-run forecast for inflation is only slightly more optimistic than CBO's. Interest rates are lower in the administration's forecast, but by less than 1 percentage point.

However, the administration's longer run projections for the 1986–89 period are considerably more optimistic than CBO's. The administra-

tion's projections show growth rates averaging about half a percentage point higher than CBO's and inflation lower by a similar amount. The largest difference between the two projections is in the area of interest rates.

BUDGET EFFECT ON INTEREST RATES

The administration's projections show substantially lower interest rates than CBO's, with the differential growing over time. Because of the rapidly rising levels of Federal debt that must be serviced, CBO's interest rate assumptions account for $75 billion out of the $124 billion higher deficit projected for 1989.

The difference in interest rate assumptions apparently stems partially from the budget assumptions. CEA Chairman Feldstein recently pointed out in testimony before the House Budget Committee that, if deficit reductions beyond those proposed by the administration are not enacted, interest rates are not likely to fall over the next 5 years as projected in the President's budget, and the growth of real GNP is likely to be slower than assumed.

Thus, both the administration and CBO seem to agree that, without substantial changes in fiscal policy, interest rates are likely to remain very high over the next several years.

Other estimating differences for revenues and outlays attributable to differing economic assumptions are relatively small compared with the difference in interest rates. CBO projects lower corporate income taxes as a result of low corporate profits and somewhat higher outlays as a result of slightly higher inflation and unemployment rates, particularly after 1986.

These estimating differences account for another $20 billion of the higher deficit projected by CBO.

The next section goes into technical differences, which I won't read.

OVERALL EFFECT OF FEDERAL DEFICITS

Federal deficits of the magnitude shown in the CBO baseline projections and under the administration's 1985 budget proposals would have major consequences both for the economy and for future budgetary choices. Most economists agree that Federal deficits of the size projected by CBO keep interest rates higher than they would be otherwise.

This conclusion is contested by a few analysts who contend that there is no historical evidence for a link between deficits and interest rates. But one should not expect to find in the historical data a simple association between the two variables. Previous deficits experienced during peacetime have been much smaller than those now projected, and their impact on interest rates has often been overwhelmed by recessions, Federal Reserve policies or international capital flows.

The current and prospective deficits are extremely large relative to past history. In fiscal year 1983, the Federal deficit was about 107 percent of domestic net private saving and 34 percent of gross private saving. Our reestimate of the President's budget implies that unified deficits would be 79 percent of net private saving and 29 percent of gross private saving during the fiscal year 1984–85 period.

FOREIGN CAPITAL INFLOWS

Fortunately, very large capital inflows from abroad have so far limited the rise in interest rates. It should be emphasized that these capital inflows are not a costless remedy for deficits. If the capital inflows continued for a long time, foreign claims on U.S. output could rise to such a level as to reduce our standard of living significantly below what it would be with less Government borrowing and less reliance on foreign capital. Moreover, dependence on foreign capital flows leaves us vulnerable to changes in the psychology of foreign investors. If, for some reason, capital inflows should dry up before the deficit situation is improved, interest rates in the United States would rise, and the dollar value would fall, thereby exerting upward pressure on our inflation rate.

In the presence of such risks, more than the usual degree of uncertainty has to be attached to any economic forecast. There is, in fact, much talk of the deficit aborting the economic recovery. Our best judgment, however, is that this will not happen in the next 2 years. We believe that the harm done by deficits accrues over the long run as the absorption of savings by the Federal Government leaves less for private capital formation and so reduces long-run growth in labor productivity. As a result, future standards of living are lower than they would be otherwise.

FINANCING COSTS

Another aspect of the high deficit is the growing cost of financing them. The most striking feature of the CBO budget projections is the extremely rapid growth in outlays for interest on the debt. Net interest costs, which were between 1 and 2 percent of GNP for decades, are projected to rise from 2.8 percent of GNP in fiscal 1983 to 3.8 percent in 1989, in our estimate of the President's budget. As a consequence of continuing large budget deficits, the stock of Federal debt outstanding rises dramatically over the next 5 years, approaching 50 percent by 1989.

In these circumstances, major spending cuts or tax increases are necessary just to avoid the possibility of explosive growth in interest outlays.

The rapid rise in the debt-to-GNP ratio also means that projections of future deficits are highly sensitive to the assumptions about interest rates, which are one of the hardest economic variables to forecast. A 1 percentage point error in the forecast, if continued through this projection period, implies a $30 billion error in the projection of the 1989 deficit.

Mr. Chairman, the rest of my testimony summarizes volume III of our annual report, which is our collection of different options by which the deficit might be reduced. The volume contains some 138 options, which I will be glad to discuss if you like.

Chairman HATFIELD. Do you want to proceed to read that?

Dr. PENNER. No. [Laughter.]

Chairman HATFIELD. We will take that up in other sessions.

[The statement of Dr. Penner follows:]

PREPARED STATEMENT OF RUDOLPH G. PENNER

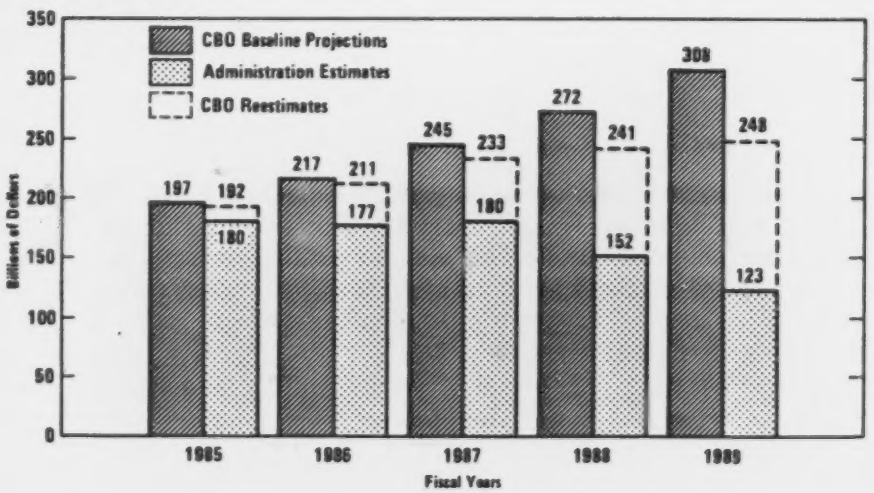
DIRECTOR

CONGRESSIONAL BUDGET OFFICE

Mr. Chairman, I am pleased to have the opportunity to appear this morning before the Committee to present the Congressional Budget Office's (CBO's) analysis of the President's budget for the upcoming fiscal year. Copies of our analysis, which was prepared at the request of this Committee, have been distributed to Members and my statement this morning will summarize its findings.

The Administration's budget proposals for fiscal years 1985-1989, as set forth in the February budget documents, do not represent major changes in current policy, either in terms of revenues or in terms of expenditures. As a consequence, using our economic assumptions and estimating methods, CBO projects that the budget deficit under the Administration's proposals would rise steadily during the next five years to nearly $250 billion by 1989 (see Figure 1). The difference between our estimates of the budgetary impact of the Administration's proposals and those contained in the

Figure 1.
Federal Budget Deficit



President's budget document can be attributed largely to different economic assumptions for 1986-1989, particularly for interest rates.

THE ADMINISTRATION'S BUDGET PROPOSALS

Under current policies, the Congressional Budget Office projects very large and growing deficits, rising from nearly $200 billion in 1985 to over $300 billion in 1989. As a percent of gross national product (GNP), the baseline deficits would decline from 5.3 percent in 1984 to 5.0 percent in 1985 but rise thereafter, reaching 5.7 percent in 1989. The CBO baseline budget projections were presented in detail in our recent annual report to the Budget Committees, and are summarized in Table 1. 1/ The numbers shown in this table have been revised somewhat to reflect new information contained in the President's budget about spending programs, and also to reflect revised assumptions about inflation in the defense sector.

The President's budget for 1985 proposes relatively modest increases in revenues, and reductions in total spending from the levels projected by CBO under current policies. Proposed increases in defense spending would be offset more or less by reductions in nondefense spending. The Administration's budgetary proposals would hold the deficit-to-GNP ratio at about 5 percent during the next three years and reduce it to 4.6 percent by 1989. Thus, deficits would remain very high by recent historical experience. The deficit-to-GNP ratio for the 1980s would average 4.4 percent, as compared with 0.4 percent in the 1950s, 0.8 percent in the 1960s, and 1.9 percent in the 1970s.

1/ See the Congressional Budget Office, A Report to the Senate and House Committees on the Budget, Part I: The Economic Outlook, Part II: Baseline Budget Projections for Fiscal Years 1985-1989, and Part III: Reducing the Deficit: Spending and Revenue Options (February 1984).

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Revenues	665	741	807	878	964	1,039
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Deficit	186	192	211	233	241	248
	As a Percent of GNP					
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Revenues	18.6	18.7	18.7	18.7	19.0	18.9
Outlays	23.9	23.8	23.8	24.0	24.4	24.6
Deficit	5.3	5.0	5.1	5.3	5.5	5.7
Administration's Program as Estimated by CBO						
Revenues	18.7	19.0	19.0	19.0	19.3	19.3
Outlays	23.9	23.9	24.0	24.1	24.1	23.9
Deficit	5.2	4.9	5.0	5.1	4.8	4.6
Memorandum: Gross National Product (In billions of dollars)	3,563	3,910	4,251	4,612	4,987	5,379

a/ The CBO baseline figures are revisions of those appearing in Congressional Budget Office, Baseline Budget Projections for Fiscal Years 1985-1989 (February 1984).

The Administration's 1985 budget reflects basically the same priorities as its 1984 budget proposal, although the size of the proposed policy changes has been scaled back. Proposed tax increases are substantially smaller than last year, primarily because the Administration is

no longer proposing a contingent tax increase beginning in 1986. The Administration's defense program is somewhat smaller than that proposed a year ago, although the requested funding levels are still greater than those included in the Congressional budget targets last year. No new proposals are made for the Social Security and railroad retirement programs, which were subject to major legislative reforms last year. Finally, the Administration is no longer requesting or has reduced in size a number of cuts in entitlement programs and in nondefense discretionary spending that it has sought unsuccessfully in the past.

The estimated budget effect of the Administration's policy proposals would be to increase revenues by a total of $77 billion over the next five years, and to reduce projected outlays by $38 billion relative to the levels in our baseline projections. The total deficit reduction for 1985-1989 is estimated by CBO to be $115 billion, as shown in Table 2. Most of this reduction occurs in 1988 and 1989 under our projections. For the next three years, which will be the period covered by the next Congressional budget resolution, we estimate that the Administration's budget proposals would reduce projected deficits by only $24 billion compared with the CBO baseline. The Administration shows a greater reduction from its current services levels, but that is because its current services projections include the cost of last year's defense proposals as estimated in the Administration's 1984 Midsession Review. CBO uses as a starting point the lower targets for defense budget authority contained in last year's Congressional budget resolution.

TABLE 2. THE ADMINISTRATION'S DEFICIT REDUCTION PROPOSALS AS ESTIMATED BY CBO (By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	Cumulative Five-Year Total
CBO Baseline Deficit	197	217	245	272	308	1,239
Proposed Changes						
Revenues						
Taxation of Health Insurance Premiums	-4	-6	-8	-10	-12	-40
Other Tax Increases	-6	-10	-12	-14	-17	-59
Tax Reductions	2	4	5	5	5	22
Subtotal	-8	-12	-15	-18	-24	-77
Outlays						
National Defense	10	21	23	20	11	85
Entitlements and Other Mandatory Spending	-4	-6	-9	-12	-15	-46
Nondefense Discretionary Spending	-2	-5	-7	-12	-17	-44
Offsetting Receipts	*	-1	-2	-4	-6	-13
Net Interest	-1	-2	-3	-5	-10	-20
Subtotal	3	7	2	-13	-36	-38
Total Policy Changes	-5	-5	-13	-32	-60	-115
President's Budget as Estimated by CBO	192	211	233	241	248	1,124

Revenues

The Administration's revenue proposals contain both tax reductions and tax increases. While contingency tax proposals in last year's budget are not repeated, a number of other tax proposals have been put forward again. This includes the largest revenue-raising item--a proposal to impose income and Social Security taxes on employer-paid health insurance premiums in excess of certain thresholds. This is projected to raise $40 billion in revenues over the next five years. Together with increased premium charges for Supplementary Medical Insurance (SMI) and spending reductions for Medicare and Medicaid, about $60 billion of the cumulative five-year deficit reductions proposed by the Administration would be targeted on the health sector.

Other revenue-raisers proposed in the President's budget include limitations on the use of tax-exempt bonds for private businesses and for students, substantially the same as those contained in H.R. 4170, and various proposals with regard to tax shelters, accounting procedures, and corporate tax abuses, many of which also have been discussed recently by the tax-writing committees. These and other revenue-raising proposals together are estimated to raise another $59 billion in revenues over the next five years.

The budget also contains a number of proposals that would reduce projected revenues by a total of $22 billion between 1985 and 1989. These include tax incentives for employers in economically distressed areas designated as enterprise zones, tuition tax credits for parents whose children attend private elementary and secondary schools, and changes in the tax treatment of life insurance companies. The largest revenue reduction proposal is the revision of the tax treatment of life insurance companies, which was considered by both the House Ways and Means and the Senate Finance Committees in 1983.

Defense Spending

The President's budget proposes $314 billion in budget authority and $273 billion in outlays for national defense programs in 1985. This is $16 billion higher than the budget authority target for these programs contained in last year's budget resolution, and $10 billion above our baseline defense outlay projections for 1985. Over the next five years, proposed funding for defense programs exceeds our baseline projections by a cumulative total of $83 billion in budget authority and $85 billion in outlays.

After adjusting for CBO's projection for inflation, we estimate that the current dollar value of the Administration's defense proposals for 1985 represent a 12 percent real increase in budget authority over 1984

appropriated levels, compared with a 3.1 percent real increase passed by the Congress last year. For 1986, the projected real increase is 7.7 percent, and for 1987-1989 about 2 percent per year. As a result of the much lower real growth projected for the period after 1986, annual real growth over the entire five-year period would average 5.1 percent. These real growth projections for defense programs are lower than those projected by the Administration because, over the next five years, we are assuming somewhat higher inflation in the economy, and more particularly in the defense sector.

The interplay of the dollar requests and defense prices is important. If the Administration's dollar requests are accepted but CBO's price assumptions prove to be correct, the amount of money budgeted would not be enough to buy all of the weapons requested or to support the force levels proposed. In this case, either the number of weapons purchased and the force levels planned would have to be scaled back, or additional funds would have to be appropriated. The estimated budget impact of CBO's higher defense price assumptions amounts to 5 percent of projected budget authority over the next five years. This potential additional cost, which works out to $94 billion in budget authority and $54 billion in outlays, is not included in our estimates of the Administration's 1985-1989 budget proposals.

Relative to last year's budget proposals, the Administration's defense program is lower by $16 billion in budget authority for 1985 and by $42 billion for the 1985-1988 period. The lower funding proposals can be attributed mostly to lower projected inflation by the Administration and to reductions in planned purchases of aircraft, missiles, and ships. Also contributing to the lower proposed funding levels is a projected real decline by the Administration in the cost of a number of weapons systems. (This is

the first time we have observed such a projected decline in our analyses of defense budgets.)

Nondefense Spending Programs

We estimate that the Administration's proposals for nondefense spending programs would lower projected outlays by $103 billion over the next five years, or less than 3 percent. The reductions from our baseline projections for 1985-1989 consist of $46 billion for entitlements and other mandatory spending, $44 billion for nondefense discretionary spending, and $13 billion in increased offsetting receipts. The indirect effect of the revenue increases and spending reductions would be to lower net interest costs by another $20 billion.

Reductions in entitlement outlays would be achieved through such measures as freezing target prices in the farm price support program, delaying scheduled cost-of-living adjustments for federal retirement benefits, shifting more costs to Medicare and Medicaid beneficiaries, and raising pension guarantee premiums. Other cost-saving measures include some reductions in means-tested benefit programs and consolidation of the child care and summer feeding programs into a nonschool food program grant to states. Many of these proposals were in last year's budget, and a few received some legislative action. The only increase proposed for entitlement programs is a 15 percent increase in veterans' readjustment benefits to be effective next January.

Spending for nondefense discretionary programs under the latest Administration's budget plan would increase by about 3 percent annually in nominal terms, compared with roughly 5 percent per year to keep up with inflation under our baseline projections. The largest reductions relative to

our baseline projections are in the areas of housing assistance, education and training programs, highway and mass transit grants, and various commercial activities such as postal subsidies, small business loans, and uranium enrichment. A few areas would receive more funds than projected under current policies, such as assistance to Central America, veterans' health care, space programs, and air traffic control activities. The budget shows a large increase in funds for foreign military sales assistance, but this is the result of shifting off-budget financing for this program to direct loans and grants that would be recorded in the unified budget.

The projected increase in offsetting receipts, which has the effect of lowering net outlays, results primarily from a proposed increase in premiums for the SMI program. Under current law, SMI premiums are set at 25 percent of program costs through 1985, and are to be increased by the growth in the Consumer Price Index (CPI) thereafter. The Administration proposes that premiums be increased gradually to 35 percent of program costs by 1990.

CBO REESTIMATES OF THE PRESIDENT'S BUDGET

CBO's projections for the budgetary implications of the Administration's proposals are significantly different from those contained in the President's February budget. We project that revenues will be slightly lower and outlays significantly higher, especially after 1986. As a consequence, we estimate that the Administration's budget plan would result in rising deficits over the next five years instead of declining deficits. The bulk of the estimating differences result from different economic assumptions, especially for interest rates. Table 3 compares the CBO and Administration projections for the President's budget program, and shows how much of the estimating differences can be attributed to economic assumptions and how much to technical estimating differences.

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Outlays						
Administration Estimate	854	925	992	1,068	1,130	1,184
CBO Estimate	851	933	1,018	1,111	1,204	1,287
Deficit						
Administration Estimate	184	180	177	180	152	123
CBO Estimate	186	192	211	233	241	248
Differences in Projections						
Revenues						
Economic	-1	-1	-2	-3	-6	-7
Technical	-4	-3	-6	-6	-9	-13
Total	-5	-4	-8	-10	-15	-21
Outlays						
Economic	2	8	17	32	59	87
Technical	-5	*	9	11	15	16
Total	-3	6	26	43	74	103
Deficit						
Economic	3	8	19	35	65	95
Technical	-1	3	15	17	24	30
Total	2	12	34	53	89	124

* Less than $500 million.

The CBO and Administration economic forecasts for 1984 and 1985 are very similar (see Table 4). Projected growth rates for real GNP are almost identical. The Administration's short-run forecast for inflation is only slightly more optimistic than CBO's. Interest rates are lower in the Administration's forecast, but by less than one percentage point.

However, the Administration's longer-run projections for the 1986-

1989 period are considerably more optimistic than CBO's. The Administration's projections show growth rates averaging about half a percentage point higher than CBO's, and inflation lower by a similar amount. The largest difference between the two projections is in the area of interest rates. The Administration's projections show substantially lower interest rates than CBO's, with the differential growing over time. Because of the rapidly rising levels of federal debt that must be serviced, CBO's higher interest rate assumptions account for $75 billion out of the $124 billion higher deficit projected for 1989.

The difference in interest rate assumptions apparently stems partially from budget assumptions. CEA Chairman Feldstein recently pointed out in testimony before the House Budget Committee that, if deficit-reduction measures beyond those proposed by the Administration are not enacted, interest rates are not likely to fall over the next five years as projected in the President's budget, and the growth of real GNP is likely to be slower than assumed. Thus, both the Administration and CBO seem to agree that, without substantial changes in fiscal policy, interest rates are likely to remain very high over the next several years.

Other estimating differences for revenues and outlays attributable to differing economic assumptions are relatively small compared with the differences in interest rates. CBO projects lower corporate income taxes as a result of lower corporate profits, and somewhat higher outlays as a result of slightly higher inflation and unemployment rates, particularly after 1986. These estimating differences account for another $20 billion of the higher deficit in 1989 projected by CBO.

Technical Estimating Differences

Technical estimating differences between CBO and the Administration affect the deficit estimates by only $1 billion in 1984 and $3 billion in 1985.

TABLE 4. COMPARISON OF CBO AND ADMINISTRATION ECONOMIC ASSUMPTIONS (By calendar year)

	1984	1985	1986	1987	1988	1989
GNP (billions of current dollars)						
CBO	3651.2	3994.8	4339.0	4703.7	5083.5	5480.5
Administration	3642.4	3973.8	4319.2	4681.2	5059.0	5444.9
Difference	8.8	21.0	19.8	22.5	24.5	35.6
Real GNP (1972 dollars, percent change, year over year)						
CBO	5.4	4.1	3.5	3.5	3.4	3.3
Administration	5.3	4.1	4.0	4.0	4.0	3.9
Difference	0.1	0.0	-0.5	-0.5	-0.6	-0.6
GNP Deflator (percent change, year over year)						
CBO	4.7	5.1	4.9	4.7	4.5	4.3
Administration	4.5	4.8	4.5	4.2	3.9	3.6
Difference	0.2	0.3	0.4	0.5	0.6	0.7
Consumer Price Index (percent change, year over year) a/						
CBO	4.5	5.0	4.9	4.7	4.5	4.3
Administration	4.4	4.6	4.5	4.2	3.9	3.6
Difference	0.1	0.4	0.4	0.5	0.6	0.7
Civilian Unemployment Rate (percent, annual average)						
CBO	7.8	7.3	7.0	6.8	6.6	6.5
Administration b/	7.9	7.7	7.5	6.9	6.2	5.8
Difference	-0.1	-0.4	-0.5	-0.1	0.4	0.7
3-Month Treasury Bills (percent, annual average)						
CBO	8.9	8.6	8.4	8.2	8.0	7.8
Administration	8.5	7.7	7.1	6.2	5.5	5.0
Difference	0.4	0.9	1.3	2.0	2.5	2.8
Inflation-Adjusted Interest Rates c/						
CBO	4.2	3.5	3.5	3.5	3.5	3.5
Administration	4.0	2.9	2.6	2.0	1.6	1.4
Difference	0.2	0.6	0.9	1.5	1.9	2.1

a. Consumer Price Index for urban wage earners and clerical workers.

b. The Administration publishes only the overall unemployment rate. The civilian adjustment is made by CBO.

c. Defined here as the Treasury bill rate minus growth in the GNP deflator.

After 1985, however, CBO's technical assumptions add substantially to the deficit estimates--$15 billion in 1986 and $30 billion in 1989. On the outlay side, the largest technical differences relate to defense spending and to receipts from oil and gas production activities on the Outer Continental Shelf (OCS). CBO believes that the Administration has underestimated the rate at which requested increases in defense budget authority will show up in outlays. Because of higher CBO defense spending rates, particularly for procurement of weapons systems, estimated outlays increased by $5 billion in 1986 and $10 billion in 1989. CBO also concludes that the Administration has overestimated likely OCS receipts by an average of $4 billion per year over the 1986-1989 period. On the revenue side, most of the technical differences are in the individual income tax estimates; they reduce estimated revenues by $3 billion in 1986 and $13 billion in 1989.

CONSEQUENCES OF LARGE DEFICITS

Federal deficits of the magnitude shown in the CBO baseline projections and under the Administration's 1985 budget proposals would have major consequences both for the economy and for future budgetary choices. Most economists agree that federal deficits of the size projected by CBO keep interest rates higher than they would be otherwise.

This conclusion is contested by a few analysts who contend that there is no historical evidence for a link between deficits and interest rates. But one should not expect to find in historical data a simple association between deficits and interest rates. Previous deficits experienced during peacetime have been much smaller than those now projected, and their impact on interest rates has often been overwhelmed by recessions, Federal Reserve policies, or international capital flows.

The current and prospective deficits are extremely large relative to past history. In fiscal year 1983, the federal deficit was about 107 percent of domestic net private saving and 34 percent of gross private saving. Our reestimate of the President's budget implies that unified federal deficits would be 79 percent of net private saving and 29 percent of gross private saving during the fiscal year 1984-1985 period. Fortunately, very large capital inflows from abroad have so far limited the rise in interest rates.

It should be emphasized that these capital inflows are not a costless remedy for deficits. If the capital inflows continued for a long time, foreign claims on U.S. output could rise to such a level as to reduce our standard of living significantly below what it would be with less government borrowing and less reliance on foreign capital. Moreover, dependence on foreign capital flows leaves us vulnerable to changes in the psychology of foreign investors. If, for some reason, capital inflows should dry up before the deficit situation is improved, interest rates in the United States would rise and the dollar's value would fall, thereby exerting upward pressure on our inflation rate.

In the presence of such risks, more than the usual degree of uncertainty has to be attached to any economic forecast. There is, in fact, much talk of the deficit "aborting" the economic recovery. Our best judgment, however, is that this will not happen in the next two years. We believe that the harm done by deficits accrues over the long run as the absorption of savings by the federal government leaves less for private capital formation and so reduces long-run growth in labor productivity. As a result, future standards of living are lower than they would be otherwise.

Another aspect of high deficits is the growing cost of financing them. The most striking feature of the CBO budget projections is the extremely

rapid growth in outlays for interest on the debt. Net interest costs, which were between 1 and 2 percent of GNP for decades, are projected to rise from 2.8 percent of GNP in fiscal year 1983 to 3.8 percent in 1989 in our estimate of the President's budget. As a consequence of continuing large budget deficits, the stock of federal debt outstanding rises dramatically over the next five years, approaching 50 percent of GNP by 1989. In these circumstances, major spending cuts or tax increases are necessary just to avoid the possibility of explosive growth in interest outlays.

The rapid rise in the debt-to-GNP ratio also means that projections of future deficits are highly sensitive to the assumptions about interest rates, which are one of the hardest economic variables to forecast. A one-percentage-point error in the forecast, if continued through the projection period, implies a $30 billion error in the projection of the 1989 deficit.

MAJOR OPTIONS FOR REDUCING THE DEFICIT

It is now widely agreed that policy actions are necessary to reduce projected budget deficits. Given the composition and dynamics of the federal budget, there is a broad consensus that these actions will have to include both spending cuts and tax increases, but still considerable differences over what proportions of each are appropriate.

On the spending side, one must start with the fact that a large portion of federal outlays occurs in only a few budget categories. Table 5 shows CBO's estimates of the Administration's spending program by major categories. Defense, entitlements, and net interest account for 90 percent of the total spending projected for the 1985-1989 period, and will exceed total projected revenues by more than $550 billion.

TABLE 5. CBO ESTIMATES OF THE ADMINISTRATION'S SPENDING PROGRAM BY MAJOR CATEGORIES
(By fiscal year)

	1984	1985	1986	1987	1988	1989
	In Billions of Dollars					
National Defense	235	273	315	352	387	419
Entitlements and Other Mandatory Spending	396	423	449	479	514	549
Nondefense Discretionary Spending	157	162	166	174	179	183
Net Interest	109	125	143	164	188	207
Offsetting Receipts	-46	-49	-54	-58	-64	-71
Total Budget Outlays	851	933	1,018	1,111	1,204	1,287
Off-Budget Spending	15	14	9	8	8	6
Total Outlays	866	947	1,028	1,119	1,212	1,293
	As a Percent of GNP					
National Defense	6.6	7.0	7.4	7.6	7.8	7.8
Entitlements and Other Mandatory Spending	11.1	10.8	10.6	10.4	10.3	10.2
Nondefense Discretionary Spending	4.4	4.1	3.9	3.8	3.6	3.4
Net Interest	3.0	3.2	3.4	3.6	3.8	3.8
Offsetting Receipts	-1.3	-1.3	-1.3	-1.3	-1.3	-1.3
Total Budget Outlays	23.9	23.9	24.0	24.1	24.1	23.9
Off-Budget Spending	0.4	0.4	0.2	0.2	0.2	0.1
Total Outlays	24.3	24.2	24.2	24.3	24.3	24.0

If changes in projected spending for defense and entitlements are to be accomplished, they must be undertaken soon. Cuts in defense procurement show up in reduced outlays only after a long time lag. Cuts in entitlement

programs, such as Social Security, Medicare, and federal employee retirement benefits, ought to be phased in gradually so that beneficiaries and providers of services have time to adjust.

CBO recently completed its fifth annual report on options for reducing the deficit. This report, which is part of our annual report to the Budget Committees, presents 138 options--not recommendations--for cutting spending or raising taxes.

In national defense, the options discussed contrast the difficult trade-off between short-term readiness efforts and long-term buildup of conventional and nuclear weapons systems, with the sobering conclusion that to bring the Administration's defense budget down to 5 percent real growth--the rate incorporated in last year's budget resolution--would require $92 billion in cuts from defense budget authority between 1985 and 1989 (using CBO's defense price assumptions). To freeze defense budget authority at the 1984 level--adjusting only for inflation--would take cuts amounting to $356 billion in the next five years.

In Medicare and Medicaid, the CBO report illustrates each of the variety of ways that federal costs could be held down: by restraining payments to hospitals and doctors, by making patients or taxpayers pay more, or by shifting more of the costs to state and local governments. A key factor in cost control and in the solvency of the Medicare program will be how well the new prospective payment system works. It is much too early to tell.

Social Security and other entitlements (including agricultural price supports) represent such a large part of budget outlays that a wide variety of proposals are already on the table. Our options cover limits on cost-of-

living adjustments, reductions in eligibility for some entitlements, restraints on federal employee retirement, and significant reductions in crop price supports.

The remainder of the budget that is subject to annual appropriations is made up of hundreds of relatively small accounts. Correspondingly, each option discussed in the section of our report on these programs yields relatively small budgetary savings. To eliminate a substantial fraction of the deficit from cuts in nondefense discretionary programs would require moving on many fronts at one time.

Our study concludes with a discussion of revenue-raising options. Here we have made a distinction between relatively small, specific changes in the tax code that, even if packaged together, would raise only relatively small sums and the bigger steps that could be taken to modify our tax system so as to raise yields. These bigger steps include major base-broadening measures, surtaxes, dropping or modifying indexing, and consumption taxes.

The analysis brings out clearly the difficulty of resolving the budget dilemma. The fact is that all spending does some good for someone and all taxes do some harm to someone, so no spending cut or tax increase will please everybody. Nonetheless, our budgetary predicament requires that the Congress make difficult choices and that it search for the least damaging package of deficit-reduction options that can command majority support. I hope our discussion helps this search.

TAXING U.S. FEDERAL BORROWING

Chairman HATFIELD. Mr. Penner, I am going to try to observe the 10-minute rule this morning, at least on the first round of questions. As you know, the President remains adamantly opposed to tax increases. At the same time, as you indicate in your testimony, the rising interest payments on our national debt require the Government to continue to borrow increasing sums of money from the private sector.

Could you explain to us this morning the economic differences between financing Government spending through taxing versus financing Government spending through Federal borrowing and the risk attendant to those two options?

Dr. PENNER. I think the first point that should be made is that, if you do not change the spending path, then borrowing at this level and taxing are really not alternative options. With borrowing at the levels that we see today, the interest costs just explode without end in our baseline projections, and the debt-to-GNP ratio expands without end. So borrowing is not a viable solution in the long run.

Truly, if you do not change the spending path, eventually you either have to tax or, unfortunately, to finance the deficit by the creation of money, which we don't want to think about.

But in the shorter run, when there truly is a tradeoff between the two, in the way we view it—and it is somewhat controversial, I must admit—the debt financing comes right out of savings, both domestic and foreign, and so reduces the level of capital formation below what it would be otherwise.

A tax, on the other hand, if properly designed, will reduce, typically, both consumption and saving in the economy. So to the degree that every dollar of extra cash reduces consumption, you have a little bit more left over for domestic capital formation in the private sector.

Now, the degree to which a given dollar tax increase reduces consumption and savings depends, of course, on how the tax is designed. In one extreme, you can think of a sales tax that affects mainly consumption and savings only a little bit. At the other extreme, you could think of some tax on the return to some saving that might come almost entirely out of saving and thereby not do much good as far as interest rates are concerned.

EFFECT ON MIDDLE-INCOME EARNER OF REDUCING DEFICIT

Chairman HATFIELD. Let me phrase the question the way it would apply. Who pays the costs in terms of borrowing and who pays the costs in terms of taxing as it relates to the middle income. I know you indicate there are different ways you apply these taxes, but let's say under the most probable kind of taxes that we have in place, how might we adjust those tax structures?

How is the middle-income earner of this country affected any differently through the borrowing than if we were to adjust the current tax rates which would put some emphasis upon the tax to reduce the Federal deficit?

Dr. PENNER. As far as the middle-income earner is concerned, different groups of them are affected rather differently by the borrowing. The ones that are hurt most by the borrowing are people who are affected by higher interest rates—people thinking of buying a house, people thinking of financing a car, and so on.

The other group that could be hurt very badly by the borrowing are people in our trade sector. The linkage there is somewhat more complicated, but as we see it, our borrowing raises interest rates in this country. That attracts foreign capital from abroad to buy our securities. The foreigners have to take their francs and marks and buy dollars with those first. That drives up the value of our dollar. That makes it harder for our exporters to compete abroad; it makes it easier for importers to compete in this country.

In terms of the sectors that are most affected, agriculture is certainly one because sales depend so heavily on foreign sales. With a high value of the dollar, a given world price is translated into fewer dollars for our farmers. People in our heavy industries—in steel and autos, which are heavily impacted by imports—also suffer disproportionately. On the other hand, it has to be admitted that some people gain; some people probably would just as soon have the Government go out and borrow on their behalf rather than to face higher tax bills themselves.

When it comes to raising taxes, as you suggested, exactly who pays the tax increase depends crucially on how the increase is defined. But as a general rule, you can be pretty assured that, unless you really take efforts to try and tilt the tax increase one way or another, the middle class is going to pay a very high proportion of any tax increase because that is where all the money is.

Chairman HATFIELD. Then you would agree with my perspective that it does not necessarily follow that people are harmed or imposed upon less through borrowing than through taxing?

Dr. PENNER. No. It is a truly distributional question. There are some people who would be harmed more by borrowing; there are other people who would be harmed more by taxing. I think if our analysis is right, though, the group that you can say is truly harmed most by borrowing, and I didn't mention them, are future generations who will have to live with the lower capital stock and, therefore, a lower standard of living.

DISCREPANCY IN DEFENSE BUDGET REQUESTS

Chairman HATFIELD. Let me return to your testimony where you discuss the importance of the interplay of dollar requests and national defense prices. You seem to be saying, Dr. Penner, that CBO defense projections are maybe understated by as much as 5 percent for the next 5 years, which would require approximately another $94 billion of expenditures beyond the President's actual request in order to maintain the current systems and services.

How do you account for this discrepancy, and if it is a discrepancy as I read it, what can Congress do to protect itself and the public from these hidden cost increases in the defense budget?

Dr. PENNER. Mr. Chairman, a very large part of the difference is simply the difference in the overall inflation assumption. We have higher general inflation in the economy through the whole period than the administration does. In addition to that, we assume that the defense deflator goes up a little bit more than the general prices in the economy. That judgment is based on past history. If you look at the past, there has been some tendency for prices in the defense sector to rise a little more than average prices in the economy.

There are some signs, however, that there is some improvement in that regard. The recent SAR's hold forth the promise that real prices in the defense sector might be held down somewhat in the weapons procurement area.

We frankly have not had time to gain a complete understanding of what is going on there. It may be, however, that reforms in lengthening procurement periods may have had some influence there. If that is true, then that is promising.

We would like more time to study that whole issue. We just got that information, but we think it prudent, nevertheless, in looking at this budget, to worry about the possibility that future history will be like past history and that prices will go up somewhat more than in the economy as a whole.

But again, let me emphasize that one of the major differences here is simply a difference in the overall inflation assumption.

Chairman HATFIELD. Thank you, Dr. Penner. My time is up.

Senator Stennis?

LIVABLE INTEREST RATES

Senator STENNIS. Mr. Chairman, this gentleman is well versed in his field, and I know his testimony will help. From my point, I want to get this thing down to a level where I can understand it and feed it into the problem, the daily problems of the average person. Don't call him the little fellow, just say the average person.

He has to have a home, or rent one. He can buy one or build one, but that is where the interest rates stare him in the face. He won't get very far unless he has what I call a living, livable interest rate. I can't think of a better illustration.

I don't believe there is any way around the basic principle to it. If you just keep on spending more every year than you are taking in that you can get by with it for awhile, but you eventually cave in. Something has to give; something has to break loose. I believe that is true, and in our system, our economy and has been true a long time.

We have never been able to get around it. I think the quicker we realize it and go back to trying to do something about it at that level, the quicker we will start getting out of our predicament which is growing worse each year. I can't conceive, I can't comprehend, at least, good faith assurances made to us, honest people, and that includes the President, about balancing the budget by 1984. I think he is acting in good faith there and according to what somebody had made him believe, but

instead of that, the thing just cut loose and went to running deficits at unthinkable levels, $180 billion in 1980, maybe $200 billion per year, and some tell me that it is more than that. I don't know.

DELAYS IN ACTION ON REDUCING DEFICIT

We have to start a new pattern. We won't get anywhere by putting it off another year as I see it. I won't ask you a sensitive question, but do you see any good in just kind of sidestepping or putting this thing off for another year before we really start trying to modify the course of things?

Dr. PENNER. I think, Senator, the main problem with putting it off is, of course, that the interest bill on the debt continues to accumulate and, as you said, you have got to deal with that some time.

Senator STENNIS. That is just adding to your troubles, it is not solving them, is it?

Dr. PENNER. That is right. It is adding to the troubles at a very rapid rate in our projections. In our current policy projections, net interest costs alone go up by more than $100 billion between 1984 and 1989.

The other argument for acting quickly is to give people a chance to adjust to whatever you do. If you start to change benefit programs or if you start to change tax laws or whatever you decide to do, it is nice to get some warning about that so people can plan for it.

I think the important point to make here, however, is that it is not, in my view, necessary to take actions that actually affect outlays and receipts a great deal in 1984. What is important is to get a lot of the bargaining done to reduce the uncertainty.

Senator STENNIS. Give a lot of what? Excuse me.

Dr. PENNER. I think it is important to get through a lot of the discussion about what is possible, to exclude some things and perhaps narrow down on others. What is important, when you do change the laws, is not to close this actual deficit quickly but to tilt the spending path and receipts path, so that instead of spreading out, as they are under current law, with the deficit getting bigger and bigger all the time, they are coming closer together through time. This will show some resolve that you are clearly on the path toward lower deficits.

As you so well know, sir, in some areas, there are long time lags—for example, in the defense budget. You can change budget authority, especially for weapons procurement, but it takes a long time before that shows up in the actual outlays. But the important thing is, as I said before, not necessarily to change the actual outlays and the actual deficits, but to work toward changing the law so that we have the prospect of lower deficits in the longer run and to do that as quickly as is feasible.

CBO RESPONSIBILITIES IN BUDGET MATTERS

Senator STENNIS. May I ask you, what do you consider your primary duty now in addition to informing the membership, of course, but do you think included in your primary duties is to make firm recommendations?

Dr. PENNER. No, sir.

Senator STENNIS. As to what we should do on certain things?

Dr. PENNER. We don't make specific recommendations. What we try to do is lay out the options for you. What we have done in our volume on "Reducing the Deficit" is lay out some 138 options, which deal with specific spending programs, with entitlements, with the tax law, both in general terms and with regard to special deductions and credits and so on.

So what we see as our duty is to lay out all the options we can think of before you. I should mention that next week, on February 28, we shall be issuing a report on the Grace Commission's work in which you will see other kinds of options listed.

So all told, we will, over this month, have put an enormous number of deficit-reducing options before you. We try and state the advantages and disadvantages of them as fairly as we can, but most of them involve value judgments. As I said in response to the chairman, most of the things that we are talking about hurt some people and benefit others, and only you Members of Congress can make that choice as to who will be hurt and who will be benefitted.

Senator STENNIS. I thought your answer would be along the lines you have indicated, and that seems to me like your proper role. I judge you will be a help to all of us.

Dr. PENNER. Certainly.

Senator STENNIS. After it is all said and done, this thing is going to stand or fall, is it not, on what we do, I mean the Congress and the President, what we do towards following what commonsense and judgment we have in trying to meet these conditions and at the same time, have a way to get out, something that leads out.

Dr. PENNER. That is exactly right.

Senator STENNIS. To a high ground. That is what it comes to, them.

Dr. PENNER. Yes, sir.

REDUCE SPENDING AND INCREASE REVENUES

Senator STENNIS. All right. We have given account and weight to everything you have said to point out what you find. Regarding the conditions we are in now, is it not true that the only way to get started is to start now toward trying to lessen the outgo and increase the income, both?

Dr. PENNER. I think from an economic point of view, yes, sir, the sooner the better.

Senator STENNIS. Is there any overwhelming reason that should replace that economic view that you just referred to that you use that term? Isn't the most overwhelming thing we are faced with is to get out of this hole? Isn't that what we are called on to do?

Dr. PENNER. I think that is right, sir.

Senator STENNIS. Mr. Chairman, I know my time is about up. May I have a few more questions here? May I ask unanimous consent to insert those questions in the record, please?

Chairman HATFIELD. Indeed.

Senator STENNIS. There are a couple of pages of additional comment of my own. Well, I thank you.

Chairman HATFIELD. Without objection, the additional questions by Senator Stennis and other members of the committee will be submitted to you, Dr. Penner, for the record. They will appear at the conclusion of the hearing.

FOREIGN CURRENCY FINANCING OF U.S. DEFICIT

Chairman HATFIELD. Senator Rudman?

Senator RUDMAN. Thank you very much, Mr. Chairman.

I might note that I had the pleasure of appearing on a panel symposium that Dr. Penner attended up in Milwaukee last Thursday, and his testimony out in the hinterlands is precisely what his testimony was here today, which is very consistent, which I think is a rarity, Mr. Chairman.

Chairman HATFIELD. Especially when he is consistently right.

Senator RUDMAN. Dr. Penner, I just have a few brief questions for you. The week before last, this committee had a number of witnesses, including Dr. Feldstein. One of the questions I asked him had to do with the catch-22 situation we seem to be in with the amount of foreign money that is financing the current debt. Dr. Feldstein indicated that it was 40 percent. I assume that figure is about accurate.

He said that 40 percent of the deficit is being financed by foreign money at this time. Of course, the catch-22 derives from the fact that the very strong dollar is attracting this foreign money. It is also inhibiting our exports.

Dr. PENNER. That is right.

Senator RUDMAN. There are some things going on that might weaken that dollar. Some people think that is what the stock market may be saying and obviously, if the dollar weakens, that is advantageous from the point of view of American exports, but it is very disadvantageous in terms of the other side of this equation.

Might you comment on that?

Dr. PENNER. I think it depends crucially on why the dollar would weaken. If it weakens before we do something about this deficit problem and because people lose confidence in us relative to other countries around the world, that would be a very bad situation, indeed. We would then see, in my judgment, interest rates above current levels. While the dollar is weakening would take some of the pressure off of the export and import competing industries, it would have a very direct impact on our inflation rates, and that would be bad, as well.

On the other hand, if the dollar weakens because we take some action to do something about our deficit and take pressure off domestic capital markets, then that would be associated with, I would hope, a downward trend in interest rates and would be a much better situation for us.

The alternative situation, too, always has some chance of getting out of hand. That is to say, if the dollar weakens for psychological reasons as opposed to real reasons, that can cumulate and go very quickly. That then creates adjustment problems and, indeed, puts pressures on the Federal Reserve System to defend the dollar. That is one scenario under which this recovery could actually be aborted.

FRAGILE BALANCE OF FOREIGN CURRENCY IN DOMESTIC MONEY POOL

Senator RUDMAN. That is precisely what I was getting at. There is a body of economic thought in this country right now—you don't read a lot about it—that says that the amount of foreign money in this domestic money pool, if you will, is very fragile; that its presence is very fragile, and that under a certain set of circumstances such as some of the ones you are talking about, that could very quickly move in large amounts to the German mark, to the French franc, certainly to the yen, and if you look at currency markets in the last 2 weeks, there is starting to be a trend in that way, particularly against the West German mark.

Does that not give you some pause about your conclusion in your testimony this morning that you really don't think there is much chance of the recovery aborting over the next 2 years? Because I find some disagreement with that position among some of your very respected colleagues.

Dr. PENNER. Sir, I hope I didn't give the impression that there was not a very good chance. What I was trying to say is that, if you ask us for our very best guess, we would say no, the recovery will go on. But we say that very hesitantly for all of the factors you mentioned. If you were to ask me the No. 1 threat to that continued recovery it would be the uncertainty of the inflows of foreign capital. There could be other threats as well, obviously, but that would be the No. 1 threat. So that is our best guess, but we don't attach negligible probability to the other scenario.

FOREIGN INVESTMENT CONFIDENCE IN U.S. DOLLAR

Senator RUDMAN. I think that is a very important point, and I wanted to draw that out, because I kind of assume that is your position, that there is a threat.

Now, in order to fix that threat and to essentially keep a large pool of foreign investment in this country, the best way to do that would be for the Congress to take the kind of action that would give the foreign markets confidence in the integrity of the dollar, which would be reducing the deficit one way or the other, and very quickly. Would you agree with that?

Dr. PENNER. I do. I think you can have some dispute as to whether, if you took deficit-reducing actions, the dollar would go up or go down. Our general feeling is that it would go down a bit because a large part of the money attracted here now is so-called hot money. It has been very short-run stuff. You would very likely lose some of that.

But if that statement is wrong and if the deficit reduction so increased foreigners' confidence in us that even more money flowed in,

that would raise the value of the dollar. That would create some more problems, admittedly, for the exporters and importer competers, but on the other hand, it would have to be associated with a dramatic fall in interest rates in this country.

Senator RUDMAN. So what you are really saying is although the dollar might weaken under certain circumstances, since the stability and the economy of the country would be thus threatened and enhanced. That tends to keep foreign money. There were two reasons for foreign money being in this country: One is high interest rates. But you have high interest rates and a trench in the economy. You have a lot of hot money that is apt to be moved back and forth on very short notice.

Dr. PENNER. I would guess in the end you would have a situation with much less short-term investment by foreigners but more longer term investment.

Senator RUDMAN. I think this particular point is one that very little attention is being paid to. It is probably going to come up and bite us very soon. The reason we are having this recovery with these huge deficits is we have got a pool of this money in this country right now that is extraordinary to anything we have ever had before. Even though I think we may be borrowing, this quarter, I think 65 or 75 percent of net private financing to finance the debt, it is financed from a pool that is substantially larger than we have ever had before. Thus, there is money for cars and homes and recovery and——

Chairman HATFIELD. What you are saying, Senator, if you will yield——

Senator RUDMAN. Sure.

Chairman HATFIELD [continuing]. Is we are doing it on borrowed money.

Senator RUDMAN. We sure are, but it is not ours.

Dr. PENNER. But you can't live on borrowed money for a long period of time. That is what is happening right now.

FOREIGN-OWNED PERCENTAGE OF U.S. DEBT

Chairman HATFIELD. If you will yield to one other point. I think as you have indicated, of the 40 percent of capital, as I understand the figure, about 25 percent of the debt, in terms of the cumulated debt and the principal, is owned by foreign investors.

Dr. PENNER. I would have to check on that, but that sounds about right.

[The information follows:]

FOREIGN OWNERSHIP OF THE PUBLIC DEBT

Treasury's estimate of foreign and international ownership of public debt securities in September 1983 was about 16 percent of privately held public debt, up from about 5 percent in the late 1960s but down from about 23 percent in 1973. However, foreign purchase of Federal debt has just the same effect on the economy as foreign purchase of private debt, or reduced purchases of foreign debt by Americans. Taking all three together, changes in net foreign investment have accounted for about 40 percent of the increase in the deficit between calendar year 1981 and the end of 1983.

Chairman HATFIELD. This is opposed to some 3 percent some 10 years ago. No longer is the Rooseveltan doctrine with which we are so burdened today—as Roosevelt used to say—taking it out of one pocket and putting it into the other because we owe it to ourselves. No longer is that true because we are now owing it to other countries and other investors.

Senator RUDMAN. Mr. Chairman, I only have a couple of very short questions following that.

COST REDUCTIONS IN SOME WEAPONS SYSTEMS

On page 8 of your testimony, you stated the administration has projected a real decline in the cost of a number of weapons systems. The chairman of our Defense Appropriations Subcommittee, Senator Stevens, and I have been listening to testimony for the last couple of years along with our colleagues on that committee, and I don't really understand that assumption.

I mean, that is one that stuns me, because as a matter of fact, in some of these systems, particularly the ones covered by the so-called SAR's, the acquisition reports, I don't understand that at all. Can you give me the basis, or if you will, for the record, if you can't give me an answer now, for the record of this hearing, could, if the Chairman will allow it, could CBO give us a listing of those systems which that assumption is based on?

Dr. PENNER. I would prefer to do that for the record.

Senator RUDMAN. I would appreciate that, because that would be very illuminating.

Dr. PENNER. We just haven't had a change to sort our way through that yet.

[The information follows:]

ADMINISTRATION PROJECTION OF REAL DECLINE IN COST OF WEAPONS SYSTEMS

The Department of Defense (DoD) estimates that the cost of 43 systems (see Table 1) would be about $4 billion lower in 1985 than previously projected for the same year. The DoD also estimates that 31 systems (see Table 2) would experience cost increases totaling about $1.6 billion. Therefore, according to the Administration's estimates, the unit prices for these 74 major systems have decreased by a net $2.4 billion from the previous projected costs for 1985.

(Tables 1 and 2 follow:)

TABLE 1. MAJOR WEAPONS SYSTEMS WITH UNIT PRICE DECREASES AS PROJECTED BY THE DEPARTMENT OF DEFENSE BETWEEN JANUARY 1983 AND FEBRUARY 1984

Weapon System
Army Systems:
UH-60 Helicopter
Stinger Missile
Hellfire Missile
Multiple Launch Rocket System
Field Artillery Ammunition Support Vehicle
M109A2 Self-propelled Howitzer
Navy/Marine Corps Systems:
EA-6B Aircraft
F-14 Aircraft
F/A-18 Aircraft
CH-53E Aircraft
SH-60B Helicopter
P-3C Aircraft
SH-2F Helicopter
UC-12 B Aircraft
Harpoon Missile
HARM Missile
Standard Missiles
TOW Missile
Laser Maverick Missile
Rolling Airframe Missile
Trident Submarine
SSN-688 Submarine
CG-47 Cruiser
DDG-51 Destroyer
Battleship Reactivation
Aircraft Carrier Service Life Extension Program (CV SLEP)
LSD-41 Landing Ship Dock
LVT-7 Service Life Extension Program
Mine Countermeasures Ship
TAO Fleet Oiler
TAGOS SURTASS Ship
TAK Cargo Ship
MK-48 Torpedo
MK-46 Torpedo
Hellfire Missile
Hawk Missile
Air Force Systems:
F-16 Aircraft
B-1B Aircraft
C-5B Aircraft
KC-10 Aircraft
MX Missile
HARM Missile
Harpoon Missile

SOURCE: Compiled by CBO from data supplied by the Department of Defense.

TABLE 2. MAJOR WEAPONS SYSTEMS WITH UNIT PRICE INCREASES AS PROJECTED BY THE DEPARTMENT OF DEFENSE BETWEEN JANUARY 1983 AND FEBRUARY 1984

Weapon System
Army Systems:
AH-64 Helicopter
Patriot Missile
TOW-2 Missile
Pershing Missile
Fighting Vehicle System
M-1 Tank
DIVAD Gun
Bushmaster 25 mm Gun
M88A1 Medium Recovery Vehicle
Navy/Marine Corps Systems:
A-6E Aircraft
AV-8B Aircraft
AH-IT Helicopter
E-2C Aircraft
TH-57 Helicopter
C-2 Aircraft
Tomahawk Missile
Sparrow Missile
Sidewinder Missile
Phoenix Missile
Stinger Missile
LCAC Landing Craft
TAGS Survey Ship
Light Armored Vehicle
Captor Torpedo System
Air Force Systems:
F-15 Aircraft
TR-1 Aircraft
T-46A Aircraft
GLCM Missile
IIR Maverick Missile
AMRAAM Missile
Stinger Missile

SOURCE: Compiled by CBO from data supplied by the Department of Defense.

Senator RUDMAN. Dr. Penner, thank you very much. I, too, want to thank you for your very direct and forthright answers, and I think, very valuable testimony. I just hope people start paying attention.

Chairman HATFIELD. Senator Inouye?

Senator INOUYE. Thank you.

INTEREST ON U.S. DEBT

Your testimony describes the interest on debt in terms of percentage of personal income tax or the GNP. In terms of dollars, what will it be?

Dr. PENNER. In terms of our estimates of the administration's budget, sir?

Senator INOUYE. Yes.

Dr. PENNER. In 1984 net income is $109 billion. It rises to $207 billion by 1989. By the end of the 1980's, it is rising about $20 billion a year.

Senator INOUYE. On page 4 of your summary testimony, you described the administration's budget proposals as reducing projected deficits by only $24 billion. By that, might I assume that you consider the reduction of $24 billion over a period of 3 years to be inadequate, insufficient?

Dr. PENNER. It is small. We would like to see more progress than that, obviously.

BUDGET REDUCTIONS IMPACT ON WALL STREET

Senator INOUYE. What level of reductions would be necessary to have any significant impact on our economy or could otherwise have a psychological impact upon Wall Street?

Dr. PENNER. That question obviously involves investor psychology. I think investors will judge our policies on the basis of the degree of commitment they show for the long run, not necessarily on the basis of the actual dollar reductions in the deficit in 1984 or 1985. But if investors can see a commitment to a set of policies that at least moves the slope of the spending path and the tax path so that the two paths start to come together, that that could have a significant impact on investor psychology.

In terms of trying to think of standards by which one might judge different deficit reduction packages, we are obviously far from a balanced budget. In practical terms we can't talk about doing that, although it would be nice.

We think that an important milestone might be reached if you could at least reduce the deficit sufficiently to stop this growth in the debt-to-GNP ratio. As long as the debt-to-GNP ratio is growing, even with constant interest rates, obviously, the interest bill as a percentage of gross national product is growing. That is what really gets us into trouble in the long run. It means that a higher and higher tax rate has to be applied to our income to cover that interest bill.

So if we could stop that from growing, that might be a nice first hurdle to jump over. But even that modest standard would require defi-

cit reduction of something over $100 billion in 1987. So even that first hurdle, which is one of the least demanding we can think of, really involves rather massive changes in policy.

The $100 billion, by the way, applies to the reduction in that single year, not the cumulative amount.

Senator INOUYE. A reduction of $100 billion for the year 1987? What about the 1985 and 1986?

Dr. PENNER. You mean in leading up to that amount?

Senator INOUYE. Yes.

Dr. PENNER. You are right to say that it would depend on just the exact pattern. I guess I don't have the numbers with me, Senator, but we could supply something for the record on that.

[The information follows:]

DEBT-TO-GNP RATIO

A budget deficit reduction of $110 billion in 1987 would keep the debt-to-GNP ratio at its 1986 level. If action were taken before 1987, the task would be somewhat easier because of savings in interest costs.

ADMINISTRATION DOWN-PAYMENT PLAN

Senator INOUYE. Have you had an opportunity to analyze the President's down payment plan?

Dr. PENNER. No, we have not, sir. There is some uncertainty in our own minds as to exactly what that applies to. We have not gotten enough information at this time to do any real analysis of it.

Senator INOUYE. So you have no idea as to the impact it would have on reducing budget deficits?

Dr. PENNER. Perhaps I am not sure of what you are referring to. Are you referring to the sheet that they passed out at your first——

Senator INOUYE. Yes, the menu.

Dr. PENNER. No. We have not analyzed the implications of that policy for the longer run.

Let me say, sir, while I mentioned a rather demanding first hurdle, I truly do believe that any progress you make will be beneficial simply because it will show resolve in doing something about it. I think it is very important to have discussions because this, as you so well know, is a terribly complicated problem.

There are literally an infinite number of options that are before you that conceivably you could consider. So even narrowing down those options somewhat and excluding the ones that have no political support adds a lot of merit to it very quickly.

FUTURE DEFICIT CUTS

Senator INOUYE. So in order to make a significant first step, in 1987, the reduction should be $100 billion and building up to that, I presume, $50 billion or $85 billion and for 1986?

Dr. PENNER. That is a possible first hurdle. On the other hand, any bit will help. And I should emphasize in all of this that, because interest costs are so important in all of this, when I talk about cutting the

deficit by $100 billion in 1987, not all of that need be in program changes. Every time you cut a dollar out of some continuing program, by the end of 5 years, that is $5 less debt that you have put out in the marketplace. You have saved the interest on the $5 of debt, and all the interest on the interest that you would have been borrowing to finance debt service. So you really get a multiplier there. It is something of a reward.

In chapter 4 of volume II of our annual report, we look at the sensitivities of the budget to various things. We show, for example, the effect of borrowing $10 billion. It is on page 64 of volume II of our report. We show the effect of borrowing $10 billion, more or less, each year for other outlays. By 1989, that effect is $.7 billion, so you get that extra bonus. So all of these changes I am talking about need not be in program content.

But again, let me emphasize that I use that standard just as illustrative. Because the situation is so unstable, any progress you can make is very helpful.

HARD-CORE UNEMPLOYED

Senator INOUYE. My final question, sir. With respect to your analysis of unemployment rates, it has been often suggested that we have in the United States a large number of men and women who have given up and they are counted as part of the street people or the hard core unemployed. Is that included in the number of unumployed?

Dr. PENNER. That we project over time?

Senator INOUYE. Yes.

Dr. PENNER. Yes.

Senator INOUYE. These are people who have not applied for unemployment compensation or are not looking for jobs, now.

Dr. PENNER. Let me clarify. Discouraged workers—people who have given up looking for jobs—are not included in the unemployment statistics or forecast.

In terms of our long-run outlook for unemployment, well, let me back up and say in terms for the economy, which we really can't forecast very well, we have just assumed that the economy grows in accordance with past historical experience. Under that assumption, the unemployment rate falls by the end of our projection period in 1989 to about 6.5 percent.

That, in our judgment, would not be sufficient to get down to that hard core that you are talking about—those who are really very difficult to employ because of skill problems or other problems. So in that sense, it is not taken into account.

On the other side, if we could figure out some way as a society to exploit that resource, to get those people to be productive members of our work force, we could, then, probably talk about more growth. So it is, in that sense, a great waste of resource.

Senator INOUYE. About how many Americans are part of the hard-core unemployed?

Dr. PENNER. That is extremely difficult to measure, sir. There is an excellent book by Ken Auletta called "The Underclass" which looks at these very hard core people and specifies all sorts of measures. It really is a matter of definition. We can look just at the number of what are called discouraged workers—and I think they are different from the people you are talking about. Discouraged workers are simply people who are not looking because they don't think there is a job available. We have made considerable progress there recently as employment has gone up. The number of discouraged workers reached a peak, as you would expect, in the fourth quarter of 1982 at 1.8 million, and has fallen now to 1.5 million.

So that number is coming down fairly quickly, but I am afraid that it doesn't really go to your question.

I don't have a good answer for you because it is so sensitive to just how you define that hard core.

Senator INOUYE. Thank you very much.

Chairman HATFIELD. Thank you, Senator.

Senator Mattingly?

FLIGHT OF FOREIGN CAPITAL TO U.S. MARKETS

Senator MATTINGLY. Dr. Penner, good to see you. Just to follow up on Senator Rudman's comment about the flight of capital, foreign capital, I assume you agree that the reason why it all came here was because the United States is a so-called safe haven; is that correct?

Dr. PENNER. I wouldn't use the term "all," sir.

Senator MATTINGLY. A great percentage?

Dr. PENNER. A significant portion is because of political stability here, and also because of the sluggish recovery in Europe compared to ours.

Senator MATTINGLY. Right. Wouldn't that also mean when we talk about it leaving, the capital leaving, won't it leave not only as a result of, say, not doing anything about the deficit, but also because as the recovery comes to these other countries, won't the invested capital also move out because of that?

Dr. PENNER. It could very well, sir.

Senator MATTINGLY. Well, no. It would, wouldn't it?

Dr. PENNER. Some of it would.

Senator MATTINGLY. The capital you are talking about that was invested here as a safe political or economic haven, a great deal of it would be retrieved and invested elsewhere.

Dr. PENNER. Yes, some.

Senator MATTINGLY. So even though we do all the things we should do to reduce the deficit, and probably nothing is going to happen, but if we did do all these things, and get the deficits down some capital would still leave?

Dr. PENNER. You are right.

Senator MATTINGLY. Capital will leave?

Dr. PENNER. If the Europeans experience a greater recovery than is

forecast by their consensus, and their consensus forecasts are really very, very pessimistic, but you are absolutely right. If profit prospects in Europe suddenly rose relative to those in the United States, you would see some movement.

IDEAL DOLLAR SCENARIO NOT POSSIBLE

Senator MATTINGLY. My point is that we are never going to have an ideal situation. Way back in 1978 and 1979, we had a weak dollar, and everybody was worrying about that. Now we have got an overvalued dollar and everybody is crying about that. I don't think there is a perfect scenario out there where we are going to have a perfect dollar, because it is not a perfect world; isn't that correct?

Dr. PENNER. I don't like the terms "overvalue" and "undervalue" very much, but I agree people tend to complain whichever way they see it. But standing back and looking at it as an economist, all other things equal, I think it is better to have a higher valued dollar than a lower valued dollar.

CBO PREDICTION OF FUTURE INTEREST RATES

Senator MATTINGLY. Good. Your statement notes the difficulty of accurately predicting future interest rate levels. What has been CBO's success rate in predicting future interest rates?

Dr. PENNER. Interest rates is the variable that we predict least well of any. I can't compare our accuracy record with OMB's. We have done an analysis of the accuracy of our forecasts on all of the main variables since the beginning of CBO. It is not a long history, obviously, only 8 years, but I found it very interesting, and the hardest variable to forecast is interest rates.

Senator MATTINGLY. But whether it is CBO or OMB or Chase or whomever it may be, predicting beyond 1 year into the future gets into a real danger zone, doesn't it?

Dr. PENNER. There has been a strong tendency in budgeting in past years to be much too optimistic about where the deficit was going; where the economy was going. This year we have based our longer run projections on the historical record rather than on a hope as to where things might go. We think this gives us a more realistic forecast of what might happen. It still may be too optimistic, as many in the past have been, because we have no business cycle on our long-term projections. We have very smooth growth. We have based our long-run projections on past history, as I said, even though in recent years productivity has been lower than past history and, indeed, productivity is somewhat disappointing in this recovery period.

GNP-TO-DEBT RATIO INCREASE

Senator MATTINGLY. On page 17 of your testimony you cite the rapid rise of the GNP-to-debt ratio and how it really creates quite a bit of flexibility.

Dr. PENNER. That is right.

Senator MATTINGLY. You note that a 1-percent error in the interest forecast could create a $30 billion error in the projection of the 1989 deficit.

Senator Inouye mentioned the impact that the down payment proposal would have, and there is a group now with Secretary of the Treasury Regan on tax reform. What do you think about proposing a similar group on spending reform to try to do something for the long term? I know everybody will say: "Well, that is the Congress responsibility," but I am wondering.

Dr. PENNER. Are you talking about an outside commission of some sort?

Senator MATTINGLY. Either outside or inside; it doesn't make any difference to me.

Dr. PENNER. I am hard-pressed to see where that could possibly do any harm. I think there is a necessity to narrow down the options somewhat. As you suggest, however, in the long run it is the Congress that will have to vote on the particular proposals. It is interesting to note in connection with the work of the Greenspan Commission on social security, that when the Congress actually took on that problem, it went beyond the Commission's recommendations: The Congress didn't just swallow them wholesale but were, in a sense, more radical, in particular with recommending the extension of the retirement age in the 21st century.

Ultimately, it is the Congress that will have to do it, but the more information you can get from various sources, the better I guess. I certainly can't complain about that, since we are in the information business ourselves.

Senator MATTINGLY. I guess what I mean is when you get past all the yelling and screaming up here, that really, the down payment is something that probably should be done. The composition of it may be left up in the air right at the moment, but as far as for the long term, we ought to be pursuing that. If it takes the Congress to do it, maybe the Congress ought to get together and do it and not wait for your projections to be right.

Thank you.

Chairman HATFIELD. Thank you, Senator.

Senator Bumpers?

EFFECT OF INTEREST RATE INCREASES ON NATIONAL DEBT

Senator BUMPERS. Dr. Penner, first of all, I want to thank you and CBO for what I think is a very candid and intelligent approach to the problems we find ourselves in. Let me ask you two or three questions about the effect continuing increases in interest on the national debt are going to have on the viability of our economy.

I noted in your statement you consistently refer to interest as a percentage of GNP, but let me give you another analysis. In 1985, corporate and personal income taxes are expected to total about $405 billion. Most people don't really relate to that, because we are talking

about a $925 billion budget. But actually, only $405 billion of that are corporate and personal taxes.

There is another $100 billion in excise and other things, but we think of social security payments and medicare as dedicated revenues available only for the financing of social security and medicare.

What I am trying to get to is the competence factor. Now, in 1980, interest on the national debt as a percentage of corporate and personal income taxes collected was only about 16 to 17 percent. In 1985, it is going to be 28 percent. Now, economists, CBO, all of us talk about the devastating effects of the deficit, because it is going to cause interest rates to climb; this is going to abort homebuilding and automobile sales and that is going to abort the recovery, et cetera.

I see another, what I think is probably a more devastating effect of these deficits, and that is at some point, the unwillingness of the American people to take paper as a form of indebtedness in the U.S. Government. That will truly be devastating if we reach that point. But if you stretch this out to about 1989, according to your own figures and according to revenue estimates by this administration, the percentage of interest on the national debt, the percentage of corporate and personal income taxes go up even higher.

Do you see that as a problem in the coming years?

Dr. PENNER. It is a very serious problem, sir. Indeed, even now, given our baseline assumptions under no policy changes, I would suggest that that is just as serious a problem as the crowding-out concept—namely, the concern that the interest bill will get so burdensome that we won't want to tolerate it. Now, I think we are a long way from that now, because we were really, in retrospect, fiscally responsible for the long period from World War II to 1974. Over that long period, our deficits were small enough that the debt-to-GNP ratio came down very smartly. It is since 1974 that that ratio has been on an upward trend and, of course, since 1980 on an accelerating upward trend. That is of grave concern if extrapolated out. There is a concern. I am not predicting it, please don't misunderstand me, but there is a concern that you just won't tolerate it and, as I said before, then there is only one other choice, and that is printing money.

STOCK MARKET REACTION TO CONTINUED DEFICITS

Senator BUMPERS. I think the stock market is saying right now that if you are going to continue to write $200 billion worth of hot checks a year and you are not willing to tax yourself or to cut defense spending or take the other necessary politically courageous actions to reduce the numbers of those hot checks, we don't have much confidence in the future.

I think the stock market is also saying, Dr. Penner, that they don't think 1985 is going to be as good a year as you do.

You have alluded in your testimony that you think two more good years, and yet most economists think we are going to have a fairly significant downturn in 1985. How do you account for that difference?

Dr. PENNER. Well, we, again, as I said before, we put forward our forecast very tentatively, but we really see the harm done by this deficit as being a long-run harm and not a short-run harm. I guess what it shows is that there is some Keynesian blood in our veins yet. We see some stimulative effect.

Senator BUMPERS. You have vaccinated the President. He seems to be a Keynesian, too. [Laughter.]

Dr. PENNER. The question is, precisely the one that you raise, however. Another way to put it, I suppose, is how short is the short run? Eventually, it does become a problem of confidence, just as you are suggesting, and I don't know exactly why the stock market is behaving the way it is right now. I guess I would be richer if I understood it. But certainly, what you suggest is a possible hypothesis; that people are getting a little shaky. There are, I think, two elements to the question. One is their actual expectation, and the other is the degree of certainty or risk that is attached to that expectation. Our expectation is a good one. Our best guess is a good one. But we attach a very high element of risk to our best guess. Even if the stock market were making the same best guesses as we are, the very fact that the risk went up could cause the stock market to go down.

Senator BUMPERS. Mr. Penner, I find your testimony for the most part right on target, things that I believe make sense to me.

CBO 2-YEAR FORECAST

There is one thing in here that doesn't make sense, and I think you could probably clarify it for me, and I am going to ask you to. You say in your statement that you think we have 2 more years of fairly good economic conditions, but in looking over table 5, your statistics right on out through 1989 show a remarkable lack of downturn in any of the economic assumptions.

You show interest rates remaining stable, at about where they are right now. You show a declining unemployment rate; you show a constant consumer price index; you show a fairly consistent growth in the GNP. How do you square not just, say, it looks like things are going to be pretty good through 1989, because those economic assumptions seem to indicate that things are going to be good until 1989. I would like to believe your assumptions, incidentally. I don't, but I would like to.

Dr. PENNER. Sir, I guess I didn't make that as clear in the testimony as I should. I hope we have in our various reports. We regard only 1984 and 1985 as being a forecast.

Senator STENNIS. Excuse me. Excuse me. I didn't——

Senator BUMPERS. He says he only regards 1984 and 1985 in their economic forecast.

Dr. PENNER. As a forecast. The projection beyond 1985 is in no way necessarily consistent with the policy path that we are on, in our judgment. It is purely a historical projection to give you a basis for evaluating various changes in policy. We do not think of it as being consistent with the policies now in place.

Senator BUMPERS. I am not sure I understand that. I am curious. Frankly, I would just as soon you hadn't put those assumptions in there, except apparently you have to do something since the administration carries their projections out to 1989.

Dr. PENNER. Yes.

Senator BUMPERS. I can't understand economic assumptions, for example, where you show the deficit being $248 billion in 1989 and a consistent climb in the deficits. With all that that portends, I can't understand the consistency of that kind of projection with a stability that is shown here in every other economic assumption. That doesn't make any sense to me.

Dr. PENNER. They are not intended to be consistent. Looking that far out into the future, we think it would be ridiculous to assume that no policy has changed whatsoever. We have a great deal of difficulty, obviously, knowing what we should do out there. We cannot set goals for the economy. That is not our role. We cannot forecast policies. We can't forecast what you all are going to do over that period. We know you are not literally going to keep policies constant. So, in the longer run, we resort to simply assuming that the economy, in one way or another, will proceed according to past historical tendencies. As we suggest in our report, we certainly think that would require some change in policy from the current levels.

LEGISLATIVE ACTION TO REDUCE DEFICIT

Senator BUMPERS. Dr. Penner, let me give you a proposition that I believe is correct. I am not laying my political future on the line, but my guess is that Congress will make some effort. I don't think this bipartisan committee is going to amount to anything. I think the legislative process will work, and that the Finance Committee and the Ways and Means Committee will come up with some reduction in the deficit. It is not going to be very dramatic, but it is going to be something, because nobody is going to want to run this fall and stand there and say, "I did nothing." I think what is going to happen, if President Reagan is reelected in 1985, I think in the Presidential address in the fall of 1985, we are going to get a collateral probability of consumer taxes along with the value-added tax. There will be a high-falutin name on it. It won't be called the value-added tax, but the effect will be the same. It will be a consumer tax. If I am right in that assumption, which economic class in the United States would the burden fall hardest on as a percentage of their income?

Dr. PENNER. It would obviously depend on how it was designed. You are talking about——

Senator BUMPERS. Something along the lines of a value-added tax.

VALUE-ADDED TAX PROPOSAL

Dr. PENNER. In Europe, most of the value-added taxes have either exemptions or reduced rates for things that are generally considered to be necessities, so that takes the burden off the lower income groups somewhat.

It is not as simple as most people think. Most people just immediately think of a consumption tax being regressive, because if you just look at the data, lower income people tend to consume more of their income than do upper income people.

But there are complications. There are complications because of the way the thing can be designed to exempt necessities, if you like. There are complications because it is typically assumed that, if you levied a value-added tax, it would appear in the price level immediately. We have protected large numbers of the people in lower income levels from changes in the price level by the indexing of various programs, social security, SSI, food stamps, et cetera.

So those people living on those programs would be protected to some degree. States have not typically protected people living on AFDC fully against inflation. So it is a very, very complicated issue.

Senator BUMPERS. But you think those classes can be protected with some kinds of tax credits and that sort of thing from, I assume, something, an inordinate share of burden?

Dr. PENNER. I think so. That is not to say that I think you can do it perfectly, but I think you can make a lot of adjustments that move in that direction.

Senator BUMPERS. Thank you, Mr. Chairman.

Senator STEVENS [presiding]. Thank you.

EFFECT OF INTEREST RATE ON DEFICITS

I am sort of confused. I want to get to the defense side, but my memory is, in 1974, the interest rate that was being paid by the Federal Government was somewhere around 6.5 to 7 percent. In this year's budget, we have $165 billion on the $1.3 plus trillion national debt. It seems to me if we had the interest rate that was enjoyed in 1974, we would have a deficit projection right now or somewhere around $80 to $90 billion. Would you disagree with that?

Dr. PENNER. I would have to think about that a little bit. It is——

Senator STEVENS. I would like to see you do that and pull out this; that since 1976 we have come through inflation rates that were almost 20 percent, and interest rates that exceeded 14 percent, as far as the Government was concerned.

Dr. PENNER. My statement regarding 1974, if that is what you referred to.

Senator STEVENS. I am just referring to the overall question about what is causing this deficit. It just seems to me that if you look at this deficit now, we have to look at your chart you pointed out on Government borrowing. The impact of not paying any of the interest in the last 8 years and borrowing the interest as we roll over the debt shows not only in the total national debt but it shows in the current projected deficit.

Dr. PENNER. Absolutely. I misunderstood you.

Senator STEVENS. Maybe I am being too simplistic. But this is how I look at interest rates; if interest rates were down to the period of the

Ford adminis-tration and previous to that, we would not have a projected deficit problem to deal with of the magnitude that we do now.

Dr. PENNER. It would certainly be of a lesser magnitude. If I followed you, I don't think it would be quite that big a change, but certainly a change from the current circumstances.

EXCERPT FROM LETTER ON DEFENSE BUDGET

Senator STEVENS. As Chairman of the Defense Subcommittee, let me ask you a few questions about your defense comments. In 1982, and I will put this in the record as a whole so that you can see the whole letter, I asked your predecessor about the ability of Congress, really, the flexibility if Congress, to make changes in later defense budgets. Ms. Rivlin wrote back to me on September 13, 1982, and stated, among other things—and as I said you can have the whole letter:

> As we have noted in previous analyses, this emphasis on procurement will make it more difficult to reduce defense outlays quickly in future years. Procurement contracts generate outlays over a number of years. Thus, under the Administration plan, the percentage of defense outlays required to pay for contracts signed in prior years would grow, and these outlays are almost impossible to avoid.

BUDGET AUTHORITY PROGRAM

In your statement, you indicated that as far as budget authority, the administration's program is lower by $16 billion, and that that has resulted mostly because of lower projected inflation and to reductions in planned purchases of aircraft, missiles, and ships.

Now, as a practical matter, in past years, we have had a series of years in which the budget outlays have been less than budget authority. Isn't Ms. Rivlin's projection now coming true that we are going through a period where the outlays are going to be in excess of the requested budget authority? In other words, are we not going to be paying the bill for the past authorizations that were contained in the budget years over the last 3 to 4 years?

I think President Carter started the first increase.

Dr. PENNER. There is certainly a catch-up in proportionate terms, sir. But in terms of the administration's request, budget authority is still outrunning outlays.

Senator STEVENS. Yes, it does, but not by much, and as——

Dr. PENNER. No.

Senator STEVENS [continuing]. As we go to the outyears, that is where we are going to have to play catch up. I was trying, again, I want to put this whole letter of hers in the record, but I was trying to point out then the problem of that excessive budget authority in terms of control of out-year budget outlays. The bill is coming due, isn't it?

Dr. PENNER. Absolutely. We are paying for decisions made in the past with regard to procurement, no doubt about that.

ALTERNATIVES TO REDUCED SPENDING

Senator STEVENS. I know that you annually do some reports on alternatives for reducing spending, and I've got to tell you, I am a little puzzled by this year's proposal. Last year you would have cancelled the F–18 and bought more A–6's. This year you don't mention the F–18, but you want to terminate the A–6's. Last year, you called for canceling MX. This year you want to limit increases.

This year, you want to cancel the C–17 in favor of more C–5's. In other words, I find it a difficult thing to track your recommendations in terms of the past two recommendations that you have made to us. You have picked up on some things we have tried to do, limiting construction increases of attack submarines, slowing ship production, and apparently suggesting limiting military pay raises and outpatient fees for CHAMPUS.

All of those suggestions require consideration, but my real question to you is, doesn't your report show that we really don't have many options to reduce defense spending when the authorization is already there and the production lines are going?

Dr. PENNER. I think that is right, sir. With reference to the MX missile, the option we consider this year is different because we are one more year down the road. That is true every year you continue with procurement of a certain system, as with the F–18. Then the unit costs change and so on, so that your own considerations of what is possible do change through time.

We are victims of the past. Indeed, we are still living with some of the decisions of past Presidents. The procurement time is so long, especially for something like an aircraft carrier. Obviously, the next President will have to contend with what you all do.

PAYMENT OF MILITARY EQUIPMENT AUTHORIZED BEFORE 1980

Senator STEVENS. The tanks coming off the line now were authorized before 1980 before this President took office, and the cost of those tanks has gone up substantially from $600,000 to $2.7 million a copy.

Dr. PENNER. That is right.

Senator STEVENS. So we are paying the bill now, this year. I am trying to make the point: We don't have much flexibility. I think there are a lot of people here, including some of my friends from the press, who think we have great flexibility to reduce this defense budget and to really whack it down, but with the constituency that each one of these weapons systems have, from the tanks, the F–18's, the B–1's, the submarines, the carrier, the cruisers, all of them are ongoing production which would mean increasing unemployment if those production rates were lowered. I don't see many options to reduce this budget except in the area of operation and maintenance, which is readiness. I note that, thankfully, you don't have many suggestions for reducing readiness.

Dr. PENNER. I hope, sir, that we succeeded in getting exactly that message across in chapter 2 of our volume III of our annual report. This is what you have been referring to.

Senator STEVENS. Yes.

Dr. PENNER. We tried to make that point very clear. Just to get from the administration's path to the budget resolution that was passed last year takes some rather dramatic and difficult changes, let alone to get to zero real growth or some more dramatic change in the outlay stream.

DEFENSE REDUCTIONS FOR CURRENT YEAR

Senator STEVENS. I hope that you make that point very dramatically to our friends in the Budget Committee, because too many of them are telling us and the Defense Appropriations Subcommittee to get ready for a substantial reduction in defense outlays for this year.

Dr. PENNER. The important point, I think, is the one that I tried to make before: That I think in terms of the psychology of investors and the general tone of the market, it is not so important how many dollars you actually reduce the 1985 deficit. The thing to remember in something like defense is that it is important to look at options now that will save money in 1988 and 1989, way out there. That becomes more possible, obviously, but——

Senator STEVENS. But we are borrowing interest dollars, too, just as we are borrowing dollars for defense.

Dr. PENNER. Absolutely.

INTEREST VERSUS DEFENSE SPENDING

Senator STEVENS. There would be a more favorable outlook for the future if interest spending came down 1 percent than if defense spending came down 1 percent, because defense spending, if you look at it, is going to level off by 1987. It doesn't look as if interest spending is going to level off by 1987.

Dr. PENNER. By the same token, every dollar you save in a program like defense or whatever saves you on the interest bill.

Senator STEVENS. Well, I agree with that, but you don't have to continue to pay year after year on defense costs on a 5-year modernization program. It will expire, but interest is going to go on and on the way things are going right now.

I want to congratulate you in your review of the defense budget. I really do think that you have been realistic, and I hope that your friends who review it are equally realistic about what the options are for this year and the coming years.

Now, according to the procedure, Senator Specter is next.

I will put this letter in the record. I look forward to visiting with you on that.

[The document referred to follows:]

CONGRESSIONAL BUDGET OFFICE
U.S. CONGRESS
WASHINGTON, D.C. 20515

September 13, 1982

Honorable Ted Stevens
Chairman
Subcommittee on Defense
Senate Appropriations Committee
Room 1225, Dirksen Senate Office Bldg
Washington, DC 20510

Dear Senator Stevens:

This is in response to the questions, asked in your recent letter, about the long-run costs of defense. Specifically, your letter asked for information on the flexibility the Congress will have to make changes in later defense budgets and the U.S. ability to support the forces we are now buying. This letter summarizes our preliminary findings and indicates further efforts that we plan. A memo already sent to your staff presents more details.

The Administration has proposed substantial defense increases. Under the program proposed last February, defense budget authority would grow from $263 billion in 1983 to $408 billion by 1987. Even after adjustment for inflation, this would amount to a real increase of 13 percent in 1983 and an average of about 7 percent in each year from 1983 to 1987. Outlays would also grow sharply, with real growth averaging 8 percent a year in 1983 to 1987.

The buildup in defense emphasizes procurement. About 34 percent of the 1983 request for budget authority would be devoted to procurement, and the fraction rises to 38 percent by 1987. By contrast, only about 26 percent of defense budget authority went for procurement in 1981. This increase in procurement includes funds for the purchase of many complex weapons systems, including the B-1B bomber, the MX missile, the M1 tank, Navy ships, and numerous others. (An attachment to this letter lists selected weapons programs and their effects on budget authority and outlays.)

As we have noted in previous analyses, this emphasis on procurement will make it more difficult to reduce defense outlays quickly in future years. Procurement contracts generate outlays over a number of years. Thus under the Administration plan, the percentage of defense outlays required to pay for contracts signed in prior years would grow, and these outlays are almost impossible to avoid. Under the Administration's program, outlays from prior-year budget authority would increase steadily from about 30 percent of the defense budget in 1982 to about 40 percent in 1987.

It may also be increasingly difficult to reduce future growth in spending on the operating accounts. The desire to improve defense readiness may require higher spending on operations. At the same time, large numbers of complex equipment will enter the inventory and could push up operating costs--perhaps more than the services expect. For example, analysis done by CBO for your Subcommittee suggested that costs of operating a battalion of the new M1 tanks could be about 36 percent higher than those for operating the existing M60A3 tank, even though the Army is counting on increases of only about 12 percent.

These trends suggest the long-term importance of defense decisions to be made in the next few years. If the defense buildup proceeds as planned, it will be increasingly difficult to cut back substantially on defense outlays in later years without cutting the operating accounts that contribute to defense readiness. If there are no major cutbacks, the Administration's planned spending may well be adequate, since the plan substantially increases spending for both procurement and the operating accounts. The Congressional Budget Office has not completed the analysis that should allow us to be more specific about the magnitude of any problem; we expect to do that analysis in time for next year's defense review.

The foregoing discussion concentrated on the Administration plan as proposed last February. The Congress has begun making changes in that budget. The defense authorization bill reduced the 1983 budget by about $5.7 billion in budget authority and $2.6 billion in outlays. The 4 percent limit on 1983 pay raises, plus the version of military construction bill approved by the Senate and other legislation, could bring the total 1983 cuts to $9.3 billion in budget authority and $4.7 billion in outlays.

While significant, the changes made to date will not fundamentally alter the potential problems in later years. Even with the reductions made to date, the share of defense budget authority devoted to procurement will not change substantially. Thus the percentage of outlays required to pay for contracts already signed will still grow. Nor have the cuts greatly altered the numbers of new weapons that will enter the inventory and hence the possible pressure on operating costs.

The Congress, to date, has imposed significant cuts on the defense budget for fiscal year 1983. The 1983 defense authorizations largely meet the budget authority reductions specified in the First Concurrent Resolution, but not the cuts in outlays. The Congress must now determine whether it wishes to impose further reductions in order to meet the outlay objectives. It is important to recognize that any further cuts will also affect the degree of flexibility available to the Congress in future years. If the Congress chooses to minimize additional budget authority reductions while meeting the outlay cuts specified in the First Concurrent Resolution, most reductions will come in fast-spending operating accounts. Such an approach will not improve the uncontrollable outlay growth problem noted above. Alternatively, if greater reductions were made in slower-spending procurement accounts, the Congress will slow the prior-year outlay growth problem at the same time it meets the outlay objectives specified in the First Concurrent Resolution. The first approach would require budget authority reductions equal to about $12.8 billion while the second approach would necessitate reductions in budget authority about $18.5 billion. (The attached staff memo provides more detail.)

At your request, the Congressional Budget Office expects to analyze in more detail the long-term trends in defense costs in time for next year's defense review. My staff will work with yours to make sure that this information is useful to the Subcommittee. If I can be of more help on this issue at this time, please let me know or have your staff contact Mick Miller (226-2840).

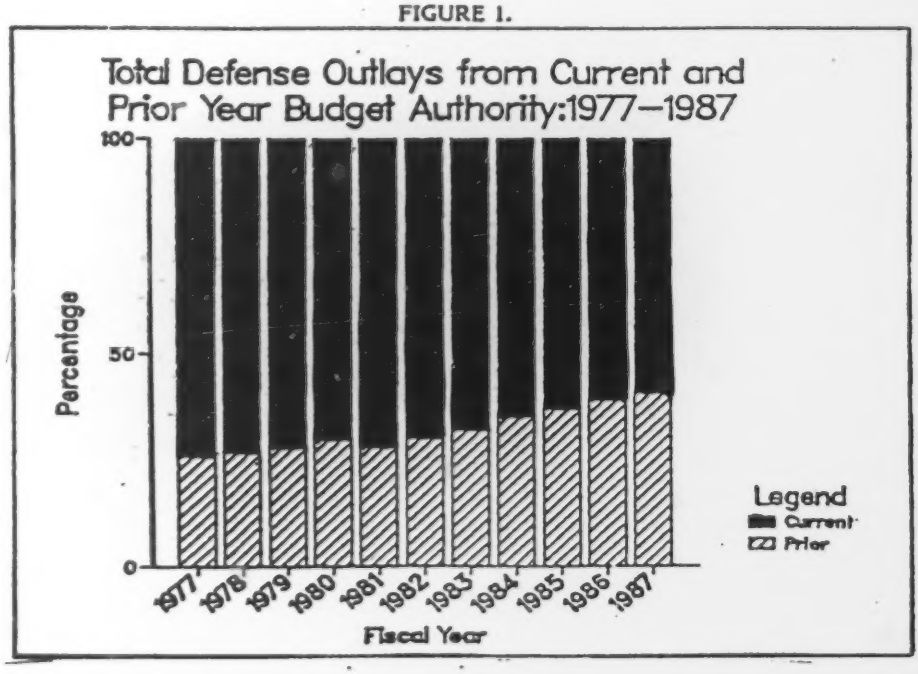
With best wishes.

Sincerely,

Alice M. Rivlin
Director

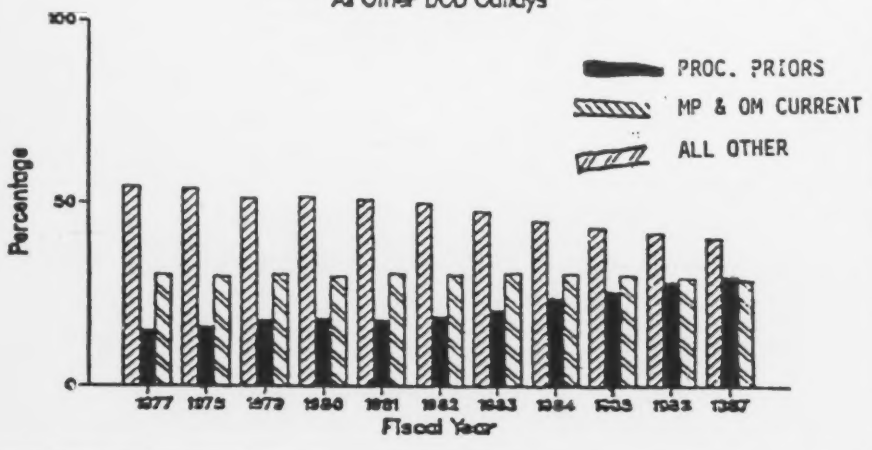
This discussion points to the problem noted in our analysis of the President's Budget 1/; defense outlay growth through the late 1980's will occur, in large part, because earlier procurement appropriations will be executed then and put increasing pressure for possible reductions on the fast spending accounts. Figure 1 shows that implementing the President's procurement intensive program causes the share of outlays from prior-years' funding in each years' projected outlays to rise steadily from about 30 percent in 1982 to about 40 percent in 1987. Thus, by approving programs with a larger modernization component, the Congress risks an outyear dilemma characterized by intensified competition for resources between modernization and readiness needs. If future defense budgets fall short of the real growth targets assumed here, the increasing share of the outlays required to finance previous years' programs will only further limit Congress's flexibility to establish or readjust priorities in defense programs. Figure 2 shows the relative decline of first year outlays from military personnel and operation and maintenance accounts compared with procurement outlays from prior year appropriations and all other outlays which includes nondiscretionary outlays for retired pay. Finally, Figure 3 illustrates outlay composition changes in more detail.

FIGURE 1.



1/ An Analysis of the President's Budgetary Proposals for Fiscal Year 1983, Congressional Budget Office, February, 1982.

FIGURE 2. Comparison of Current Operations Outlays, Procurement Outlays from Prior and All Other DOD Outlays

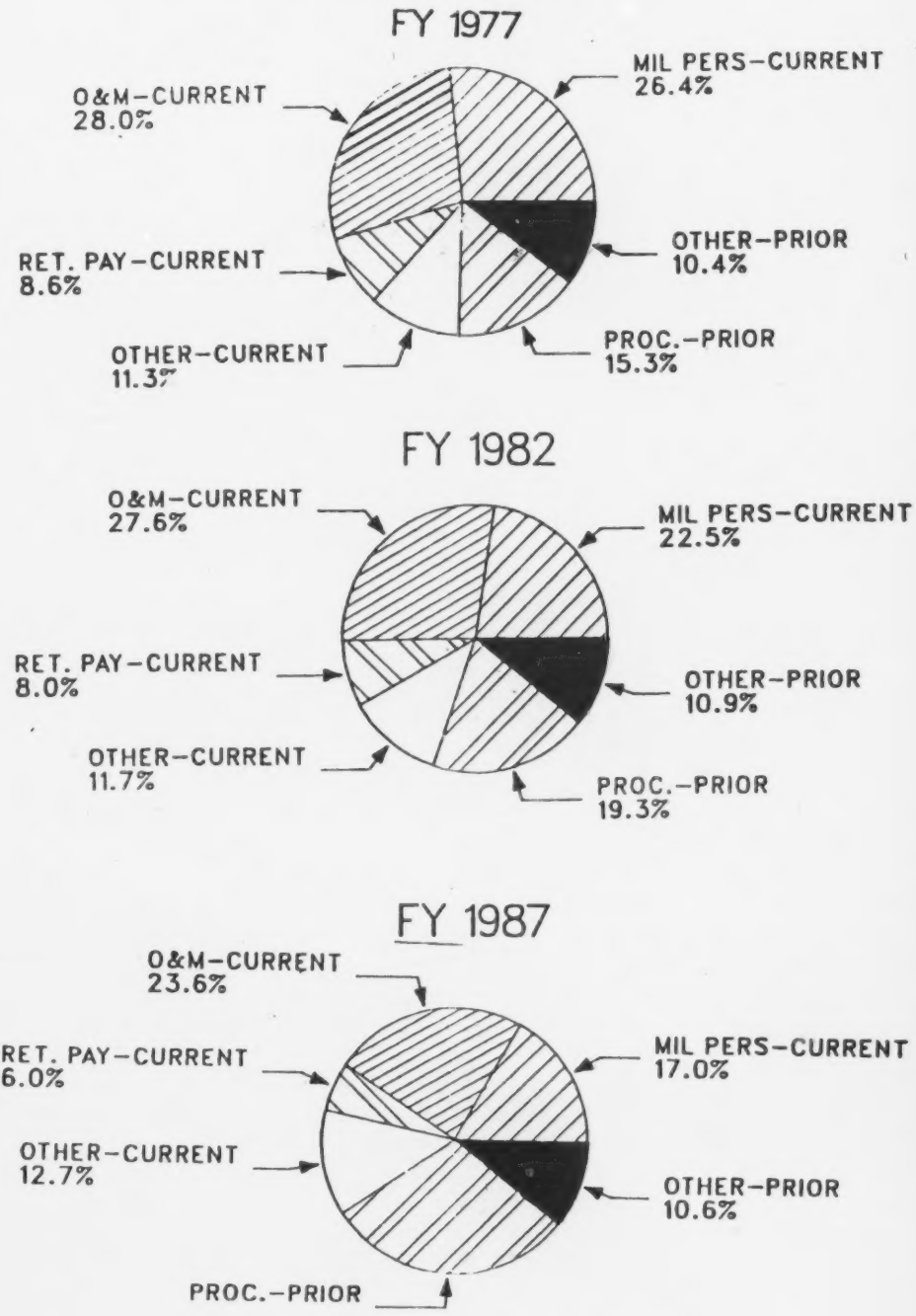


Of the scenarios discussed above, only scenario 3 would have an impact on the outlay trends shown in Figures 1 and 2 because it makes the deepest reductions in procurement. The trends will occur as long as procurement budget authority rises more rapidly than fast spending budget authority. Also, remember that these trends are shown as percents of total outlays; in real dollar terms, military personnel and O&M programs increase each year through 1987 leaving room for reductions, if required, that do not necessarily mean declining readiness.

Most of this discussion has ignored the program implications of possible scenarios so the next two graphs will provide some programmatic context. We have projected the President's 1983 request through 1987 assuming enactment of the Administration's force and investment programs as explicitly and publicly announced. 2/ The projection does not include a planning wedge. Figure 4 compares budget authority for the President's Request, the budget resolution, the CBO projection, and the three scenarios. Figure 5 compares outlays for the same projection recognizing that each scenario has the same outlays as the resolution. The main analytical upshot is that to the extent an alternative exceeds the DRM projection the reduction could occur from the Administration's planning wedge, i.e., it would not necessarily offset current and known programs.

2/ For a discussion of how these projections are made see Baseline Budget Projections for Fiscal Years 1983-1987, Congressional Budget Office, February, 1982, especially pages 81-89.

FIGURE 3: Distribution of Current and Prior Defense Outlays By Budget Function



Reductions from the President's Request for National Defense (Function 050) in Authorization and Appropriation Action to Date (Fiscal year 1983, in millions of dollars)

	Appropriation Bills						Authorization Bills					
	House		Senate		Conference		House		Senate		Conference	
	BA	O	BA	O	BA	O	BA	O	BA	O	BA	O
Regular 1983 Bills												
Defense												
Military Personnel	--	--	--	--	--	--	87	84	285	276	165	160
Retired Pay	--	--	--	--	--	--	--	--	--	--	--	--
Operations & Maintenance	--	--	--	--	--	--	1,431	1,190	807	659	1,117	901
Procurement	--	--	--	--	--	--	2,949	369	4,209	552	3,154	411
RDT&E	--	--	--	--	--	--	1,949	1,156	925	550	1,207	717
Other	--	--	--	--	--	--	1,766	787	--	--	--	--
Military Construction	1,212	253	--	--	--	--	303	25	1,376	168	--	--
Atomic Energy Defense	--	--	--	--	--	--	8	1	182	55	--	--
HUD-Independent Agency	128	66	--	--	--	--	0	0	108	84	100	60
Treasury-Postal	--	--	--	--	--	--	--	--	--	--	--	--
1982 Supplemental												
Defense	344	516	344	451	344	463	--	422	--	150	--	353
Military Construction	--	51	--	51	--	51	--	10	--	10	--	--
Atomic Energy	--	1	--	9	--	7	--	--	--	--	--	--
Selective Service	--	2	--	2	--	2	--	--	--	--	--	--
Other Bills												
H.R. 6317	--	--	--	--	--	--	220	213	--	--	--	--
H.R. 6955	--	--	--	--	--	--	--	--	212	212	260	260
Totals	1,684	889	344	513	344	523	8,763	4,257	8,104	2,716	6,003	2,862

NOTE: All bill action on this table is through passed except the HUD appropriation bill in the House, the atomic energy bill in both house and the pay bill, H.R. 6317, which are through reported.

MODIFICATION OF CONSUMER PRICE INDEX ITEMS

Senator SPECTER. Thank you very much, Mr. Chairman. I would like to pursue just a few questions here this morning. When Miss Rivlin testified on prior years, there was some discussion as to possible modifications of the way of computing the consumer price index, for you to make it more realistic, perhaps somewhat lower, to have smaller cost of living adjustments.

Do you see any items which are currently included in the consumer price index which might appropriately be modified down?

Dr. PENNER. We did reform the index, and we now have a new index. The basic problem a few years ago was the treatment of housing expenditures, and I think the new index called the CPIU, or urban, does a good job of treating that the right way.

The problem is that the indexed programs are still indexed to the old-fashioned index, the so-called CPIW. That, however, is not causing problems at this moment.

Problems would arise if long-term interest rates took an upward jump, thereby increasing mortgage costs, which, by general agreement, are exaggerated in that index. By the same token, if interest rates should go the other way, that index probably would understate the true impact on ordinary people.

So right now, the problem that you mentioned is not a serious one, but eventually, I think we should go to this better index for the indexing of our various programs.

HOUSING FACTOR REEVALUATION

Senator SPECTER. What net change was there in the reevaluation of the housing factor?

Dr. PENNER. The net effect of that? I would have to look that up, sir, and supply it for the record.

Senator SPECTER. Did it go down?

Dr. PENNER. Oh, yes.

Senator SPECTER. But about how much?

Dr. PENNER. Let me back up. It all depends on which way interest rates are going. If interest rates are going up, the new index would go up less than the old one. If interest rates are going down, the new index would go up somewhat more than the old one. So it all depends on the direction of interest rates. But we do have data on how much that would have changed things over the late 1970's when it was a real problem for us.

Senator SPECTER. Do you have a ball park estimate at the moment?

Dr. PENNER. I don't have that in my head, sir, no.

[The information follows:]

REVISED TREATMENT OF HOMEOWNERSHIP

If the revised treatment of homeownership had been in effect between the beginning of 1972 and the end of 1982, the CPI for all urban consumers would have risen by about 0.6 percentage points less each year, on average. This calculation is based on the comparison between the actual increase in the CPIU and the increase in an experimen-

tal measure of consumer prices, published prior to the CPIU revision, which used an approximation to the revised homeownership calculation. A revised CPI-W, used for social security calculations, would have come out out similarly lower over this period. The reason for the difference is that over this period house prices rose faster than other prices, rents rose slower, and the mortgage rate was higher at the end of the period. In other periods, when these conditions do not obtain, the revised CPI could conceivably rise faster than the unrevised CPI would have done.

MODIFICATION IN HOUSING FACTOR

Senator SPECTER. As I recall, there was a change in the housing factor to account for the fact that many people didn't have to buy housing. Was that modification made?

Dr. PENNER. With the new index, we look at something called rental equivalent. There is an attempt to figure out how much owner-occupied houses would rent for on the open market, and that is considered to be their cost. The old technique, in contrast, looked at changes in the mortgage payment and made it seem as though those had a much greater effect than was realistic.

REVISED CONSUMER PRICE INDEX

Senator SPECTER. When you talk about, still, a new consumer price index, a better one, what would you look to change in such a revised CPI?

Dr. PENNER. You mean if we went beyond what we have now?

Senator SPECTER. Correct.

Dr. PENNER. The most difficult thing to handle in the price index is quality change. The BLS does make some attempt to do that with certain products, such as automobiles.

Senator SPECTER. What do you mean by quality change?

Dr. PENNER. Well, the nature of goods changes over time, so how are we to say what the prices of those goods really are? How do you compare, for example, a brand new stereo system with the older 78 recordings of 20 years ago? It is extremely difficult to contend with brand new products. How do you deal with a personal computer? How do you deal with a hand calculator? How do you deal with products that were not available way back when? Back in the 1960's, you could play a game with your economics classes and say, OK, you think prices have gone up a lot since the late 1940's. But if I give you a certain number of dollars to spend, would you rather order from the 1949 Sears catalog or the 1962 catalog? Prices have gone up, but the nature of the goods you can buy, the wider array of the goods you can buy, in a sense, make those dollars worth more and counter general inflation.

It is very difficult to adjust for that kind of change. But I think we should work a lot more on trying to make appropriate adjustments for quality changes, particularly in this era when the kinds of goods we are buying are just exploding in type and variety. I am thinking mainly of all these communications devices and computing devices that didn't exist a few years ago.

Let me correct something I said before. I had noted that we have this

reformed consumer price index, but we still use the old one to index programs. I hadn't realized that the old one, the so-called CPIW will itself be reformed in January 1985. So that will, indeed, be taken care of.

Senator SPECTER. Is it your expectation that it will go up or down, or do you know?

Dr. PENNER. It all depends on interest rates. If you believe our own forecast which has interest rates fairly stable, it is not going to make a difference right away. Indeed, I should say that since the new index came out the two have moved remarkably together.

EFFECT OF INTEREST RATES ON DEFICIT

Senator SPECTER. Moving over to interest rates for just a moment, at a meeting just this morning, I heard a recurrent theme which is the subject of a lot of debate and controversy as to whether the deficit affects interest rates.

I heard a long statement that there was no empirical evidence that, in fact, the deficit does affect interest rates. For a long while around here, we functioned on the proposition that the deficit had a catastrophic effect on interest rates.

What is your view on that subject?

Dr. PENNER. My own view is that, yes, there is a positive relationship between the deficit and real interest rates. It is important to stress the "real" here. That is the interest rate after you adjust for the effects of inflation. Now, that is a statement made largely on the basis of what I would call commonsense. If the Government absorbs a very high proportion of world savings, then the price of those savings left over to the private sector is going to go up.

Senator SPECTER. So that is commonsense and not empirical evidence?

Dr. PENNER. The empirical problem involves the question of trying to estimate the so-called real interest rates. They are a function of the interest rates you see in the marketplace and what the investor expects in the way of inflation over the life of whatever security that is being purchased. That is an extraordinarily difficult thing to estimate. We have got to get inside the heads of investors to try and figure out what that is. That is no easy trick.

In our annual report on the economic outlook, we reviewed some 25 studies of this relationship. While the empirical evidence is certainly not overwhelming, our interpretation is that the empirical evidence leans in favor of the proposition that there is a relationship, despite all of the extraordinary difficulties in isolating that relationship from all of the other things that affect interest rates.

POSITIVE RELATIONSHIP BETWEEN HIGH DEFICITS AND HIGH INTEREST RATES

Senator SPECTER. You say that there is a relationship and that it is positive. How much quantitatively? Doesn't the enormous deficit have the commonsense and practical effect of raising interest rates a great deal?

Dr. PENNER. I would suggest that is correct. Again, I am talking about real interest rates. I guess you probably don't have volume I of our annual report before you, but in the introduction to that report on page XVII, we show the comparison between real treasury bill rates in the current recovery and in previous recoveries.

Senator SPECTER. What page are you on?

Dr. PENNER. That is XVII. It is right close to the front of the volume I document.

Senator SPECTER. I do not have that.

Dr. PENNER. Would you take that up?

In the lower right-hand panel there, you see the relationship between the real interest rates during this recovery and the average of all of the postwar recoveries. You can see a spread of between 2 and 3 percentage points. I don't want to say the whole spread is due to the deficit, but I would suggest that a very large portion of it is. A smaller portion would be due to the difficulty of squeezing inflationary expectations out of this economy given the inflation we went through in the late 1970's and early 1980's.

OTHER FACTORS AFFECTING HIGH INTEREST RATES

Some of us who emphasize a relationship between interest rates and the deficit are sometimes interpreted as saying that deficits are the only thing that affect interest rates. That is nonsense, obviously. There are a myriad of factors. I would also point out——

Senator SPECTER. As much nonsense as saying the deficit doesn't affect the interest rates?

Dr. PENNER. Let me also warn against the proposition——

Senator SPECTER. After you warn against, come back to my question.

Dr. PENNER. Yes. Let me warn you against the proposition that, if deficits don't matter to interest rates, they don't matter at all. Let me give you a couple of reasons why deficits may not affect interest rates. One reason is that we do live in an international capital market that is very, very deep. Therefore, you might be able to float a lot of U.S. Government debt without affecting essentially world interest rates very much.

But if that were true, our deficit would be converted immediately into a capital inflow, and, therefore, immediately into the crowding out of our export and import-competing industries.

So the deficit would matter very much to the nature of economic activity, but not to interest rates. Similarly, you might have a situation that some have claimed existed in the 1970's and before, where the Federal Reserve offset any effect of deficits on interest rates by buying a large portion of any additional debt that was issued.

There is some evidence that supports that proposition. It would imply there was no observable link between deficits and interest rates if the Federal Reserve really did succeed in stabilizing interest rates. But it would mean that any increased deficit would be financed by money creation. The crowding out would be by inflation rather than other means.

KEMP-ROTH REVENUE LOSS

Senator SPECTER. My time is up. Let me interrupt you. I just want to ask you one more question, if I may, in two parts before deferring to Senator Abdnor. That is, how much is involved in the revenues lost by Kemp-Roth? That is part A, and part B is, if that portion had been collected by the Government in taxes, it would have reduced the deficit, is it your opinion that there would be a greater stimulus to the economy by reducing the deficit to that extent or by having the tax cut for whatever infusion that brings in the capital market?

Dr. PENNER. Sir, I find your first question very difficult to contend with, because the only way we can sensibly answer that now is by making the rather dubious assumption that, if you had not had those tax actions in 1981, nothing else would have changed—the economy wouldn't have changed, you wouldn't have had other tax cuts, and so on. That clearly gets more dubious the further you get from the event.

However, making that assumption, the numbers I have here are for the Economic Recovery Tax Act of 1981. That resulted in a dollar reduction, under these artificial static assumptions, of $40 billion in fiscal year 1982. That grew to $135 billion in 1984 and $166 billion in 1985.

TEFRA

The Tax Act that was passed in 1982, took some of that back, namely, in 1985, some $37 billion. We also had the gas tax increase with the highway bill. That was another $4 billion. We had the social security amendments. We have had the repeal of witholding on interest and dividends. You add it all up, the total tax changes—again, under these static assumptions—amounted to $117 billion in 1985 evaluated with the economic assumptions we are using today. You would get a different number if you evaluated those changes with the economic assumptions used at the time they were passed.

Senator SPECTER. All right. Thank you very much. I will pursue the other aspect of your question privately. Thank you very much, Mr. Chairman.

INDEBTEDNESS AND INTEREST RATES

Senator ABDNOR [presiding]. Thank you very much, Senator Specter.

Mr. Penner, very nice to see you back. We were conversing here last week on the Joint Economic Committee. I am not an economist. I went to a university and took finance, but the more I read of you very visual economists, I am not too sure that those on the outside who are reading all the comments of the various economists in this Nation are coming to very good conclusions.

I believe there is a key relationship between indebtedness and interest rates. I notice that in your projections here, the growth rates projected by the CBO and the administration don't vary that much. Most of the difference is due to CBO projecting higher interest rates.

A couple of weeks ago I was talking with Mr. Volcker and I think it was just the day before that I read an article by him that said if we were to cut $50 billion from the deficit this next year it would have an

effect that would certainly continue the degree of recovery that we are enjoying at the present time. I went on to question him, and I asked if it would change interest rates. I said, "Do you think rates would drop 1 percent"? He said, "Yes." I said, "Two percent?" He said, "Yes." I said, "Three?" He thought I was going too far.

But what do you think, do you agree with that in any way?

Dr. PENNER. I have no reason to disagree.

Senator ABDNOR. That a $50 billion reduction——

Dr. PENNER. $15 billion?

Senator ABDNOR. $50, $50 billion reduction in the administration projected deficit which is, I believe, now $183 billion, would be enough, if it was in the right direction and a long-range program; to have that kind of an effect on interest rates. If that is the case, it certainly shows that deficits play a big part in interest rates. I was just wondering if you could find anything wrong with that viewpoint.

Dr. PENNER. I have no trouble with that statement of Chairman Volcker's at all. Again, I would go back to the point I made earlier that a large part of this is psychological. There are different ways of cutting $50 billion from the deficit in 1986. For example, if you cut it all by cutting capital expenditures of the Government so that the next year we were up again by $50 billion, that obviously wouldn't impress people very much.

But if it is cut by genuine changes, long-term changes in programs, then I think that would have a very important psychological effect.

SURTAX AND CLOSING OF LOOPHOLES

Senator ABDNOR. Part of it that way, part of it through loophole closing. I am sure Senator Dole could come forth and in no time at all with several proposals to close a lot of what he called loopholes and different things. We could always add a surtax. Even if you broke it up 25/25, $25 billion reduced expenditures and $25 billion coming from taxes and closing loopholes, we would apparently continue to enjoy the economic recovery we are experiencing at this moment.

As far as anything that anyone had predicted 1½ years ago, I don't recall in those joint economic committee meetings where anyone was saying anything optimistic. All you could hear was the doom and gloom. That was what the economists that we had in there were saying and here now we are seeing this remarkable change.

Now you are hearing all kinds of predictions as to whether it is going to continue or not.

It is hard to argue that we are not in an economic recovery, but how do you reconcile huge deficits with the economy that we have right now?

Dr. PENNER. I think you can put it in very simple terms for the layman, sir: As I said before, I think the simplest way of putting it is that a nation, just like a family, can live very well on borrowed money. We have got all these foreigners who are willing to lend us money. If the family can find a banker to lend it money, it can have a very nice standard of living in the short run.

But eventually that banker is going to get suspicious if the family is borrowing so much that the burden on the debt is growing faster than its income. At some point in time, the banker is going to say, "No more. We are not going to lend any more." Then the day of reckoning comes, and dramatic changes in living style are necessary.

There are many differences between a government and a family, but I think the similarities here are greater than the differences.

Our Government can live well on borrowed money as long as those foreigners—indeed, domestic investors as well—are willing to buy Government debt. But we have got to reflect on the fact that some day that is going to come to an end.

FOREIGN INVESTMENT IN UNITED STATES

Senator ABDNOR. That is one point I was going to ask you. It seems foreign investments haves kept us going for awhile.

Dr. PENNER. It has been extraordinarily helpful.

Senator ABDNOR. We got a lot more savings out of our income before we started all of these new trends for supposedly encouraging savings. Now, 5 or 6 percent of the income goes into savings in this country.

Dr. PENNER. Personal income, yes.

Senator ABDNOR. Do you see anything that can happen in the next year to discourage foreign money from coming in?

Dr. PENNER. Yes. As I said to Senator Rudman before, I think that is the No. 1 threat on the horizon as far as the economic recovery is concerned. We do not forecast an end to that inflow. We assume it can be sustained over the next 2 years.

TENTATIVENESS OF FOREIGN INVESTMENTS IN UNITED STATES

But of all of the tentative things in our forecast, I think that is one of our most tentative judgments. If the foreigners lose confidence in us for one reason or another—if they think we won't cure this deficit problem, for example—or if the European countries begin to take off and drag money out of the United States——

Senator ABDNOR. That would be disastrous, wouldn't it?

Dr. PENNER. Pardon?

Senator ABDNOR. That would almost be a disaster, wouldn't it?

Dr. PENNER. No, I don't think I would characterize it as that. I think we are better off if Europe is growing well than if it isn't.

Senator ABDNOR. If they pull the large sum of money they have here——

Dr. PENNER. Yes, but if they pull money out because of European recovery, I would expect it to be fairly gradual. If it is because of a change in psychology and confidence in the United States, that could be much more damaging, because that could occur very quickly and very abruptly. It would be very difficult to adjust this, too. It is conceivable that the Federal Reserve would have to step in to defend the dollar in those circumstances. That could, indeed, abort the recovery.

That would be one of the more likely scenarios for aborting the recovery.

FARM ECONOMY FOR COMING YEAR

Senator ABDNOR. A concern of mine is that this is the time of the year the farmers of this country are making their plans for the planting season. Very, very few of them are not going to have to go to banks for some source of lending in order to find the capital to get into the field. That does not mean large purchases of new machinery; that means simply to operate. I am afraid some of the bankers are hesitant to make loans right now with the high interest rates and the kind of low returns. I don't care what they talk about in farm books. A 2 percent drop in interest rates would do more for farmers about as quickly as anything I could think of. I have written all the lending agencies in government, some of the organizations about banking asking for their projections on this, because it is a huge problem. I just returned from South Dakota, and I tell you, that has got to be the number one problem. I know the world is not South Dakota, but I think its a problem in a lot of the other farm States, too. I am afraid there isn't anything very encouraging coming out at this moment.

If interest rates don't come down, I don't see any dramatic changes.

My time is up, too.

Senator SPECTER. My time is back?

Senator ABDNOR. Yes.

VARIABLES REGARDING DEFICITS

Senator SPECTER. Thank you, Mr. Chairman. I would like to pursue the question that I started on with you, and that is, of a valuation, recognizing the difficulties of all the variables, intervening events. But one of the tough questions which I think the Congress faces is trying to evaluate whether we would be better off in an economic recovery with a smaller deficit and more taxes or worse off with a smaller deficit and more taxes. But if you were to make the assumptions which you have and project the Kemp-Roth to not pass, we would have a much smaller deficit now. If you look at fiscal year 1985, and I think the figure you said was $165 billion, which may well turn out to be the deficit for fiscal year 1985 or very close to it.

Assume, if you will, that there were no deficit or a minimal deficit in the neighborhood of $25 billion or $35 billion. Would we have a greater economic recovery?

Dr. PENNER. Looking backward, or——

Senator SPECTER. Or less. If we had not passed Kemp-Roth and had those funds not been lost to the revenue side.

Dr. PENNER. You are looking back to what actually happened. It is, as you suggested, an extraordinarily difficult question to answer. One aspect of it, which is very hard to know, is whether the Federal Reserve Board would have had a different policy had it not been confronted with the large deficit prospects that it was, indeed, confronted with.

Senator SPECTER. That is one of many variables, but assume their policy had been the same.

Dr. PENNER. If you were literally——

Senator SPECTER. We have to make a great many assumptions when we legislate.

Dr. PENNER. If you were literally to assume that all other policies would have been exactly the same, and that tax policy was the only thing that changed, then I would say that was stimulative in the short run, with a longer run negative effect because of what the big resulting deficits do to our longer run potential for economic growth. But I really do think the monetary policy question is of absolutely key importance because the business cycle that we have gone through has been very largely a monetary phenomenon.

DEFERRAL OF THIRD YEAR KEMP-ROTH

Senator SPECTER. Last year when Secretary Regan appeared before the Appropriations Committee, we discussed at some length where we would be if we had a deferral of a third year of Kemp-Roth, and my recollection is that the figures came out something like $80 billion, including some out-year projections.

Dr. PENNER. That must have been cumulative.

Senator SPECTER. Yes, and the upshot was that if we had reduced the deficit by $80 billion, Secretary Regan ventured the opinion that interest rates might come down by 2 percentage points. If interest rates came down by 2 percentage points, it would be an obvious stimulus to the economy and auto sales, home sales, et cetera.

But that is a question which we are still wrestling with, whether we would be better off in the long run with more taxes and less deficit. What is your net feel on that?

Dr. PENNER. If you are truly talking about the long run, that is to say, beyond 2 years from now, as a general proposition, I think that, if that is your only choice, you would be better off to reduce this deficit.

Senator SPECTER. Even if it meant more taxes?

Dr. PENNER. Yes. That is assuming the taxes were sensibly designed. I could think of some terrible taxes that might be worse than the deficit, but——

Senator SPECTER. Well, like we had with Kemp-Roth?

Dr. PENNER. If you just talk about some across-the-board increase in taxes, I would suggest in the long run, that there would be a net benefit.

In the short run, it depends on how skillfully you use that monetary policy, again. I get right back to that.

Senator SPECTER. Thank you.

CURRENT RECOVERY TIED TO KEMP-ROTH

Senator ABDNOR. Before we adjourn, I would like the privilege of asking one more question in relation to what you are saying. Would you say then if we had never passed Kemp-Roth we wouldn't be enjoying this economic recovery to the extent that we are right now?

Dr. PENNER. That we wouldn't be?

Senator SPECTER. I think he said we would be enjoying a greater economic recovery.

Dr. PENNER. Let me differentiate between the long run and the short run. The way the question was asked, it assumed all other things were absolutely equal, including monetary policy.

Senator ABDNOR. Let's not forget we have added a lot of taxes.

Dr. PENNER. I regard that as a very, very artificial situation. I suggested that, under those circumstances, there was probably a net stimulative impact from those big tax cuts in the short run, but that the deficits they leave us cause long-run problems.

It is that tradeoff.

Senator ABDNOR. If you were to consider new taxes, you wouldn't necessarily go back to repealing Kemp-Roth, would you, the whole picture? Would you see some other areas that need attention without imposing heavier taxes across the board than those we are paying now. Would that be a true statement?

Dr. PENNER. Absolutely. I think you now have to forget the past and look at the tax system as it exists today, and then decide what options are best on that basis.

SUBMITTED QUESTIONS

Senator ABDNOR. Thank you. I guess that concludes our morning. I know you have got a lot of work to do, Mr. Penner, and we appreciate your being here.

There are additional questions which the members will submit to you for your reply. They will be inserted in the record at this point.

[The following questions were not asked at the hearing, but were submitted to CBO for response subsequent to the hearing:]

SUBMITTED QUESTIONS

EXCISE TAX ON OIL

Question: Last year the President's budget included a temporary, contingency excise tax of $5 per barrel on domestic and imported oil. This tax would have been in place for the years 1986 through 1988.

What deficit savings would be achieved if we enacted such a proposal this year?

Answer: The imposition of a $5.00 per barrel tax on imported and domestic oil would raise $62.8 billion over the 1985-1989 period. As proposed in the President's 1984 budget, this tax was assumed to take effect on October 1, 1985, and to remain in effect until September 30, 1988. The estimated annual additions to CBO's baseline revenue projections from the tax are shown below.

	Annual Added Revenues (fiscal years, billions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	0.0	19.5	20.9	21.2	1.2	62.8

Question: Would you recommend such a plan be given more serious attention at this time?

Answer: In accordance with CBO's mandate to provide the Congress with objective and impartial analysis, we offer no recommendations.

TAXES AND REVENUE - NET INTEREST EXCLUSION

Question: A 15 percent net interest exclusion--of up to $450 for single persons and up to $900 for married couples--is scheduled to go into effect in January 1985. What would be the change in annual revenue for each year from 1985 to 1989 if Congress were to repeal or defer this provision?

Answer: ERTA created an exclusion from tax of 15 percent of the first $3,000 of net interest income on individual returns ($6,000 on joint returns), effective January 1, 1985. Net interest income is defined as the difference between total taxable interest income and total itemized interest payments (exclusive of mortgage and business interest deductions). Repealing this exclusion would raise revenues by $14 billion from 1985 through 1989.

	Annual Added Revenues (fiscal years, billions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	1.0	2.9	3.1	3.4	3.6	14.0

TAXES AND REVENUE - INDEXATION

Question: If Congress and the President decided to defer or repeal tax indexing, what would be the change in annual revenue to the Treasury between 1985 and 1989?

Answer: The revenue gains from repealing (or deferring to beyond 1989) the scheduled indexing of the individual income tax brackets, zero bracket amount, and personal exemptions would be:

	Annual Added Revenues (fiscal years, billions of dollars)					Cumulative Five-Year Addition
	1985	1986	1987	1988	1989	
Addition to CBO Baseline	5.7	17.1	30.9	46.7	64.7	165.1

ADMINISTRATION ECONOMIC FORECAST

Question: Administration spokesmen have stated that their economic forecast is reasonable if we: (1) enact a $100 billion downpayment on deficit reduction now, and (2) assume further reductions to be proposed in the FY 1986 budget.

What sort of deficit reduction policy would the Administration need to propose in its FY 1986 budget in order to validate the long-run economic assumptions included in this year's budget?

Answer: CBO cannot state precisely what deficit policy proposals would be needed in FY 1986 to validate the Administration's economic assumptions for the 1986-1989 period. According to the Administration, these assumptions are not forecasts of future economic conditions. Instead, they are trend projections consistent with the economic policies and the economic policy objectives of the Administration, which assume steady progress in sustaining economic growth and in reducing inflation, interest rates, and unemployment.

It is fair to say that if no measures to reduce the deficit were undertaken, the general performance of the economy in 1986-1989 would likely be weaker than assumed by the Administration. Beyond that, however, it is difficult to put precise numbers on

the deficit reduction path that would be consistent with the Administration's projection.

Question: Do you believe that a $100 billion downpayment is too ambitious, not ambitious enough or on target with regards to tackling the deficit?

Answer: According to CBO estimates, the Administration's budget plan, if implemented, would reduce the deficit by $115 billion over the next five years. This reduction is a step in the right direction, but because of the magnitude of projected deficits it would not prevent the federal debt and, for that matter, interest payments from rising relative to GNP. According to CBO projections, the federal debt would rise from 39.1 percent of GNP in FY 1985 to 46.3 percent in FY 1989, assuming adoption of the Administration's tax and spending policies. To keep the federal debt-GNP ratio from rising during this period would require a $387 billion cumulative deficit reduction (some of which would be realized through lower interest costs). A less ambitious goal would be to prevent the federal debt-GNP ratio from rising above 43.1 percent--the figure now projected for 1987 assuming enactment of the Administration's budget. This objective would require a cumulative deficit reduction (including net interest savings) of $172 billion.

Question: What do you believe Wall Street's reaction will be if Congress fails to make the $100 billion downpayment?

Answer: To a large extent, Wall Street already may have concluded that a substantial deficit reduction might not be enacted in this election year. However, even if the Administration's downpayment program is adopted, it would reduce federal credit demands during 1985-1987 by only $23 billion, according to CBO estimates. Such a change is very small compared to total credit demands. If the Congress does not enact even modest deficit reductions, however, it would strengthen Wall Street perceptions that federal borrowing requirements are likely to remain extraordinarily large. As a result, bond prices could decline further, and stock prices might be adversely affected.

Question: Is it important for Congress to actually reduce the deficit by $100 billion or is it more significant that we demonstrate to financial markets that we can overcome the current political polarity on the deficit issue?

Answer: Clearly, both the substantive and the symbolic aspects are of great importance. In the short run, it is probably more important that the Congress demonstrate a resolve to come to grips with the deficit problem. But it is not clear that less than a $100 billion cumulative reduction in the deficit spread over the next five years is sufficient to signal such a resolve. Even if the Administration's program is adopted, the deficit would continue to grow, reaching $248 billion by 1989 according to CBO estimates. A convincing demonstration to the financial markets that the fiscal situation is under control would require a credible plan for significant reduction in the size of the deficit over time.

POSSIBLE CHANGES IN CBO FORECAST?

Question: Since your economic forecast was prepared, the estimate of 1983 fourth quarter real GNP growth has risen from 4.5 to 4.9 percent, and the unemployment rate today is close to your 7.8 percent rate for all of calendar year 1984. Would these, or any other economic developments, lead you to change your economic forecast?

Answer: Recent economic information on output and the labor market has indeed been good: the unemployment rate has continued to fall rapidly and the estimated growth in GNP for the fourth quarter of 1983 is now slightly higher. New information on prices has not been quite so good, as food prices have jumped more than previously expected in response to the winter's cold weather. Fuel oil prices, too, have been higher than expected.

In CBO's judgment these changes have been small relative to the uncertainties always present in the forecasting process. Indeed, some of them do not now seem likely to be permanent. In particular, it seems likely that food prices will fall back in a few months, as they have following some previous freezes, and fuel oil prices have already fallen from their most recent highs. The reduction of unemployment in 1984 will be much less than it was in 1983 if the current recovery follows the path of previous recoveries. And recent remarks by Chairman Volcker of the Federal Reserve Board suggest that monetary policy will not accommodate much stronger growth without further increases in interest rates, which would choke off some economic activity, particularly net exports, housing, durable goods purchases, and business investment.

In addition, the information we currently have about recent developments is, as usual, subject to revisions. While we do not expect these future revisions to alter the general picture of a vigorous recovery, particularly in the labor markets, they do counsel against too hastily changing projections on the basis of partial new information on only one quarter or a few months.

The CBO as a matter of policy does not revise its economic forecasts between the regular economic and budget projections at the beginning of the year and the regular midyear updates, except when requested to do so by the chairmen of both the House and the Senate Budget Committees.

IMPACT OF DEFENSE ON THE DEFICIT

Question: Dr. Penner, on page 7 of your testimony you outline the increase in defense spending over the next five years in terms of actual dollars and as a percentage above last year's appropriations base. I wonder if you could state for the record, what exactly is the impact on the deficit of the President's proposed defense spending increases?

Answer: The answer to your question depends on your starting point. If you start from the CBO baseline for projected

deficits for the next five years, as shown in Table 1 of my prepared statement, then the Administration's latest defense spending proposals would add to the projected deficits by a five-year total of $85 billion. This result is shown in Table 2 of my prepared statement.

On the other hand, if you start from the Administration's current services baseline, then the answer would be not an increase in the deficit, but a decrease. For example, the President's budget shows a reduction in defense spending relative to last year's request, which the Administration uses as its current services baseline. This reduction totals $53 billion over the next five years.

DEFENSE CUTS

Question: The CBO has always taken great care in its analysis of the defense budget request, and again this year has proposed a number of areas which could be cut. Examples include: cancelling specific programs restructuring the force, limiting pay and benefits and limiting increases in O&M accounts.

Could you, for the record, outline your general thinking about this years defense request, its impact on the growing deficit, and highlight two or three specific areas which Congress should address in this year's appropriations process?

Answer: As you know, the Administration has proposed substantial increases in the defense budget. Using CBO's economic assumptions, real growth in defense budget authority would amount to 12 percent in 1985 and would average 5.1 percent over each of the next five years. The growing federal deficits are, of course, a product of all tax and spending policies, not just defense policies. But changes in defense budget authority would alter the deficits. By 1989, the deficit could be as much as $41 billion lower if, instead of the Administration's request, the Congress elected only 3 percent annual real growth in defense budget authority beyond 1984.

If the Congress decides to alter the Administration's defense budget, it should keep in mind the composition as well as the size of the budget. The Administration continues to emphasize investment. In 1985 and 1989, about 50 percent of defense budget authority would go to the investment appropriations (defined as procurement, research and development, and military construction); this is substantially higher than percentages in the late 1970s and 1980. These higher percentages do not necessarily mean that operating accounts are underfunded, since the operating accounts also increase substantially under the Administration's request. But the higher percentages do mean that an increasing percentage of defense outlays (41 percent in 1989, up from 36 percent in 1985) stem from contracts already signed, which limits future flexibility to alter the federal deficit by reducing defense spending. Thus, the Congress may want changes in investment appropriations, difficult as they are, to be a substantial part of any package of reductions in the defense budget.

CBO cannot, of course, recommend specific defense changes. In our report on options for reducing the federal budget, we outlined 20 options for reducing defense spending that illustrate a wide range of choices. Many of these options have been discussed by defense experts during earlier debates. The options include changes in investment and operating accounts, strategic and conventional forces, manpower, and purchases. Each option estimates the costs and states the arguments in support of the change but also acknowledges the disadvantages. We hope that this list will provide the Committee with a strating point for your analysis.

DEFENSE VS. NON-DEFENSE DISCRETIONARY SPENDING

Question: In preparing the OMB current services budget and the CBO baseline projections, OMB and CBO both use a "zero real growth" projection for non-defense discretionary spending.

For defense spending, however, OMB uses the numbers ($) set forth in last year's budget submission, and CBO uses the numbers from last year's budget resolution.

What is your justification for using a measure other than "zero real growth" for defense in your projections?

Is 5 percent real growth, or more, in defense spending some sort of entitlement?

Answer: Five percent real growth in defense spending clearly is not some sort of entitlement, but I believe it is a more reasonable approximation of current policy than zero real growth. There has been a policy agreement for some time now for some level of real growth in defense spending, but just what the level is cannot be pinned down. Last year's budget resolution seemed to us to be as good an approximation as any other. This is the approach we took last year in our baseline projections and it seemed to work reasonably well, so we did it again this year. But our projections report this year also included a zero real growth path as well to allow for a comparison with the projections for nondefense discretionary spending programs.

CENTRAL AMERICA

Question: The President has proposed an $8 billion aid package to Central America, most of which must be approved by this Committee.

Have you had an opportunity to review this proposal and do you have any general or specific comments on the impact of the request on our current deficit situation?

Do you know what sort of record these countries have, in repaying assistance provided by loans?

Answer: The $8 billion package of economic assistance to Central America over the fiscal year 1986 through 1989 is composed of $6 billion in appropriated funds and $2 billion in loan guarantees and insurance. While the CBO baseline makes no explicit assumptions for individual countries, we can say that foreign aid identified by the President for Central America, including the 1984 supplemental, would add less than $2 billion to the baseline deficit.

The external debt burden of all the Central American countries has had a serious effect on their economic performance. The President's Commission on Central America has recommended rescheduling of external debt as a part of an emergency stabilization package. Costa Rica sought a rescheduling of its official debt in January 1983 and a bilateral agreement with the United States to reschedule its debt will soon be concluded.

DEFENSE--INFLATION ASSUMPTIONS

Question: In your baseline report of two weeks ago you estimated inflation for defense purchases would be 8.2 percent. Now you estimate such inflation at 6.7 percent.

What new information have you uncovered during the past two weeks that leads to such a steep decline in your estimate?

Answer: There are two reasons why we revised our inflation assumptions for defense purchases. First, we revised the weights used to calculate the composite defense purchases deflator to match the program mix in the President's 1985 budget. The assumption used for our projections report was based on the program mix in last year's defense budget. We normally adjust these weights each year when we get a new budget from the Administration.

Second, in reviewing our inflation assumptions for defense purchases, we discovered that they were not entirely consistent with our general inflation assumptions. There was a growing gap between our defense purchases inflation assumptions on the one hand, and our estimates for general inflation on the other, which we did not understand and could not explain. I believe it was just a technical oversight on our part. Therefore, part of the change you referred to was to make our various inflation assumptions internally consistent. I should note, however, that we still project higher inflation for defense purchases than does the Administration in its latest budget.

DEFENSE-REAL GROWTH

Question: Mr. Director, will you please state or submit for the record your estimates for each year, 1980 through 1989, of the real growth in budget authority and outlays in both the DOD budget and in the national defense function.

Answer: The following table shows the actual real growth for 1980-1984; it shows estimated real growth for 1985-1989 consistent with our baseline assumptions. Because the baseline is based on the function totals of the budget resolution, we cannot specify the real growth for only the Defense Department. The actuals for 1980-1984 indicate that real growth for the department might not differ much from that for the function over the 1985-1989 period.

	Actual					Baseline Estimates				
	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Budget Authority										
Defense Department	2.1	12.5	12.1	7.5	3.0	NA	NA	NA	NA	NA
National Defense	2.1	12.6	12.1	7.8	3.1	6.4	4.5	5.0	5.0	5.0
Outlays										
Defense Department	3.0	4.7	7.8	7.1	7.3	NA	NA	NA	NA	NA
National Defense	3.0	4.8	7.9	7.3	7.6	6.1	5.4	5.1	5.4	4.8

DOMESTIC NON-DEFENSE SPENDING

Question: Dr. Penner, on pages 9 and 10 of your testimony you describe the Administration's non-defense spending which is held at 3 percent growth while inflation is assumed to be 5 percent. The result is an effective 2 percent reduction in non-defense programs.

Moveover, because within the "non-defense" programs certain "foreign non-defense" programs receive increases (e.g. Central America) while many of the "domestic non-defense" programs will realize reductions greater than the 2 percent loss to inflation.

Is this in fact your general conclusion that domestic non-defense programs will realize an effective reduction of something greather than 2 percent?

Could you explain for the Committee how foreign assistance programs, such as the Central America supplemental, impact the near-term deficit picture and the long-term economic recovery? (That is, do these programs have immediate impacts on outlays or do they "spend-out" over time?)

Answer: With respect to your first question, the reduction in nondefense discretionary spending described in my prepared statement refers to reductions in the average annual rate of growth for these programs relative to our baseline projections. That is to say, under the President's 1985 budget proposals, estimated budget outlays for nondefense discretionary spending programs would grow each year 2 percentage points slower than under our baseline projections. For the entire five-year period, 1985-1989, this would work out to a reduction of $44 billion, or about 5 percent less than we have in our baseline projections.

If aid to foreign governments and international organizations is excluded from our estimates for nondefense discretionary spending, then the outlook is altered somewhat, as you suggest in your question. In this case, under the President's 1985 budget, estimated budget outlays for domestic programs would increase about $20 billion between 1984 and 1989, or by an average of 2.6 percent each year. Under our baseline projections for these programs, which assume that spending will keep pace with projected inflation, budget outlays would increase by about $40 billion between 1984 and 1989, or by an average of 5.0 percent each year. Thus, the projected growth in these programs would be cut in half. Over the entire five-year period, this would work out to a reduction of about $60 billion, or about 7 percent less than we have in our baseline projections.

With respect to your second question, the impact of foreign assistance programs on outlays varies greatly. Balance-of-payments assistance is usually disbursed in the year provided, whereas project assistance can take 7 years or more to disburse fully. The growth in foreign assistance, including the Central American supplemental, is predominantly the fast disbursing balance-of-payments assistance and will contribute to outlays over the next two years.

QUESTIONS SUBMITTED BY SENATOR PROXMIRE

CONTROLLABILITY OF BUDGET

Question: Dr. Penner, under the President's proposed budget, relatively controllable outlays for civilian programs would be $90.5 billion, a decrease of $1.8 billion below the current year's total. Relatively controllable civilian outlays as a proportion of total outlays would drop from 10.8 percent currently to 9.8 percent--a full percentage point. Doesn't this indicate that there is really very little this Committee can contribute to the effort to cut deficits unless we make substantial reductions in defense appropriation requests?

Dr. Penner, how would you react to the proposition that this Committee should have more discretion to control entitlement spending by, for example, having the power to freeze medicaid spending or withhold COLA increases?

Answer: I believe you are referring to a table that is included each year in the President's budget entitled "controllability of budget outlays." The relatively controllable outlays

generally are those that are estimated to occur in the budget year from appropriations for nonentitlement programs. In the President's 1985 budget (p. 9-44), the total amount of relatively controllable outlays in 1985 is estimated by OMB to be $265 billion if Congress approves all of the President's appropriation requests. Outlays for national defense programs account for $174.5 billion of this amount, and--as you observed, Senator--outlays for civilian program account for the remaining $90.5 billion. These are the 1985 outlays over which the Appropriations Committees have the greatest control. Since relatively controllable outlays for national defense programs are two-thirds of the total, I would find it difficult to disagree with your conclusion if you are talking about major reductions in 1985 outlays.

Whether the Appropriations Committee should have more discretion to control entitlement spending is a matter that the Congress must decide. I really cannot take a position on that matter. It goes beyond the CBO charter to provide objective and impartial analysis to the Congress. I would note, however, that having the power to delay or withhold COLA increases would be an easier matter to handle in an appropriations bill than a "freeze" on Medicaid spending or on any other appropriated entitlement. The latter could have all kinds of legal problems that would not be involved in withholding or delaying a cost-of-living adjustment.

DEFICIT TIME BOMB

Question: Dr. Penner, the deficit picture you have painted for us here today has been characterized by others as a "ticking time bomb." When, in your estimation, does the bomb explode? At what point will the American voter demand Congressional action?

Answer: I can't give you an answer to that, Senator. I'm not sure that there will be an explosion in the sense of a "ticking time bomb." I believe there will be a slow erosion, however, in our ability to sustain a balanced economic growth with steadily rising levels in our standards of living.

CAPITAL INFLOWS

Question: Dr. Penner, recently a spate of articles has appeared in the press about the extent to which we are reliant on foreign capital to finance the deficit and the consequences that will follow if and when this capital no longer flows into the United States. On page 16 of your prepared statement you say:

> "If the capital inflows continued for a long time, foreign claims on U.S. output could rise to such a level that it would reduce our standard of living below what it would be if we decreased government borrowing and relied less on capital inflows."

How long would it take for this scenario to unfold?

Answer: Capital inflows from abroad are not necessarily deleterious to the country's economic health. In fact, as long as they continue, a higher level of total spending is possible than would have been in the absence of such inflows. My worry about our excessive reliance on foreign capital inflows relates to the problem of their sustainability. To be sustainable, the rate of growth of our exportable output must be greater than the effective rate of interest we must pay to foreigners. If we used foreign capital to finance increased productive investment leading to a high rate of growth of exportable output, the threat of interruption of such inflows would not be serious. Since, however, capital inflows are not at present used to finance predominantly productive investment, U.S. ability to honor its obligations vis-a-vis foreign lenders may easily come into question. Should this happen, the inflow of foreign capital would be reduced, interrupted, or even reversed. The consequences of a shift of this kind would include a deterioration of the U.S. terms of trade, upward pressures on interest rates, and inflationary impulses emanating from the import sector. Needless to say, all these factors would adversely affect the standard of living of U.S. residents.

It is not possible to foretell how long it would take for this scenario to unfold. In any event, the decline in U.S. living standards is likely to be gradual rather than abrupt. They need not fall for many years below the level that would be attainable if we currently relied much less on foreign borrowing than we actually do. Nonetheless, the observed surge in net capital inflows from abroad implies that the current generation of adult Americans collectively decided to increase their own consumption at the expense of the expected lifetime consumption of all succeeding generations, living and yet unborn.

GROWTH IN THE MONEY SUPPLY

Question: Last week Secretary of the Treasury Regan said "over the last two months the money supply has grown at better than a 10 percent rate I would characterize that as sufficient". Do you think that rate of growth is compatible with your spending and inflation projections, Dr. Penner?

Answer: Despite some short-term volatility in their growth rates, all the monetary aggregates have stayed within the Federal Reserve's target ranges and close to the growth rates that are assumed in CBO's forecast. Short-term variations in money growth rates like the recent ones are difficult to interpret. If they are due to policy changes, they could have important economic consequences if they are sustained for several months. But if these deviations are attributable to special circumstances like deregulation of financial markets, they have little economic significance.

STOCK MARKET COLLAPSE

Question: Dr. Penner, many analysts attribute the recent 10 percent drop in the stock market to concern over continued huge deficits. On the other hand administration officials tend to blame the Federal Reserve. Where do you come down on this question?

Answer: It is notoriously risky to attribute stock market movements to specific factors. The sharp decline in stock prices since early January was probably due to a whole host of reasons, both technical and fundamental. It is reasonable to assume that the lack of forceful action to deal with the deficit problem contributed to the market decline. Similarly, pronouncements by Chairman Volcker that the Federal Reserve has no choice but to maintain its policy posture might have convinced market participants that stocks are losing their attractiveness relative to fixed-income investments.

Investors are well aware that high real interest rates have a depressing effect on stock prices. They are also aware that the gridlock over the budget deficit in conjunction with the Fed's anti-inflationary policy makes the prospect for continuing high real interest rates quite likely.

QUESTIONS SUBMITTED BY SENATOR STENNIS

CURRENT ECONOMIC SITUATION

Question: During our recent hearing attended by Secretary Regan, Dr. Feldstein and Mr. Stockman, I used a word to describe our current economic situation that I am reluctant to use. That word is "collapse." Do you think we have reached the point of economic collapse?

Answer: No, I would not describe our current economic situation that way. The condition of the economy has improved markedly since the recession. Output rose 6.2 percent during the four quarters of last year, close to the average of previous postwar recoveries. Incoming data seem to confirm that economic growth remains strong, and the CBO forecasts that the economy will continue to expand robustly in the short run--by 4.7 percent in 1984 and 3.7 percent in 1985. Although we do not make a forecast beyond 1985, the economy may be able to sustain a more moderate rate of expansion for several additional years without a recession.

The high level of federal borrowing remains, however, a continuous threat to the nation's economic health. The principal harm done by large deficits over a sustained period of time is their negative impact on long-run growth and future living standards. High levels of federal borrowing tend to raise interest rates and reduce capital formation in the longer run. Higher interest rates also tend to attract foreign investment to this country, which prevents interest rates from rising even more. But

the foreign investment is not without its costs: it tends to raise the value of the dollar vis-a-vis other currencies, which has a negative impact on our export and import-competing industries. In addition, we incur the obligation to pay a future return on the foreign capital, which tends to reduce our living standards if the process persists.

Yet another implication of such high deficits is that they add greatly to the uncertainties in the economic outlook--in the short-run outlook and even more in the long-run outlook. But the short-run risks, while serious, do not appear to portend a collapse.

RISK OF RECESSION

Question: Current budget projections appear to be based on a strong sustained recovery lasting well into the future. Since fiscal year 1985 will be the third year of the recovery, what risks do you see that the economy could enter a recession during the time frame of the deficit projections contained in the budget and cause a huge ballooning of the deficit and make balancing the budget a virtual impossibility?

Answer: The CBO baseline economic projections consist of two parts: a short-run forecast for 1984-1985, which is conditional on specific policy assumptions; and longer-run projections for 1986-1989, which are based on historical growth trends, and are not meant to be necessarily consistent with the policies now in place.

As implied by our forecast, we do not expect that a recession will occur in the near term--that is, through 1985. Of course, it cannot be ruled out. As you point out, the recovery will be in its third year, and the average peacetime recovery in the post World War II period has averaged slightly less than three years. Thus, historical experience suggests that it would not be unusual for a recession to begin toward the end of the third year of a recovery. In addition, as I have tried to stress, federal policies--especially budget policies--add greatly to the uncertainties in the short-run forecast and could eventually precipitate a recession.

CBO has prepared two alternative economic projection paths in an attempt to bracket the reasonable range of uncertainty surrounding the baseline budget projection. According to the lower-growth alternative, which included a moderate recession in 1986, the budget deficit was roughly $50 billion higher in 1986, and $80 billion higher in 1987, than in the CBO baseline. (See CBO's The Economic Outlook, 1984.) Such magnitudes have serious budget implications, for example, in terms of higher interest payments on the debt. They would, of course, cause a substantial increase in the deficit as compared to the baseline projections but would not by themselves make balancing the budget a virtual impossibility.

CONSEQUENCES OF LARGE DEFICITS

Question: The Administration's projections for the next five years show yearly deficits decreasing, beginning in FY 1985, while CBO's projections are for steady and large increases. For example, in the FY 1985 budget documents submitted to the Congress, the Administration shows an estimated deficit in FY 1985 of $180.4 billion decreasing to $123.4 billion in FY 1989. The CBO shows a deficit in FY 1985 of $192 billion--almost $12 billion more than the Administration's figure--increasing to a horrendous $248 billion in FY 1989. If the Administration has been too optimistic in its assumptions and the CBO is correct, what effect would these enormous deficits have on our economy?

Answer: The major reason why CBO estimates that the President's budget plan will result in rising instead of falling deficits is that the Administration has a more optimistic outlook for interest rates. The Administration's economic assumptions are predicated on the enactment of large future deficit reductions. If such legislation is not adopted, the Administration acknowledges that interest costs would be much larger than it now assumes, resulting in deficits much closer in size to those projected by CBO.

Federal deficits of this magnitude have two major economic consequences. First, they add to interest rate pressures by absorbing private saving. These pressures can be mitigated by capital inflows from abroad; but capital inflows, while adding to the pool of capital, raise the value of the dollar, thereby crowding out export industries and industries that compete with imports. Moreover, the commitments to pay interest and dividends to foreigners become a liability against future U.S. standards of living. To the extent that interest rates rise in spite of these capital inflows, business capital formation would be less than it would be otherwise, lowering future growth in productivity and living standards.

The second major consequence of large and persistent deficits is that the interest bill on the national debt would continue to grow as a percentage of GNP, increasing future deficits and raising the stock of federal debt relative to GNP. Over time, financing the federal debt could become so burdensome that pressures might be brought to bear on the Federal Reserve to monetize a larger portion of the debt, resulting in faster money growth and increased inflation.

NATIONAL DEBT

Question: Let us assume that through FY 1989, the annual deficit remains at CBO's estimated FY 1985 level of $192 billion -- that it neither increases nor decreases. Using this assumption, can you tell us what the annual interest payment on the national debt for FY 1986, FY 1988, and FY 1989 would be -- both in dollars and as a percentage of GNP? Using the same assumption, what would the national debt be in FY 1989? What effect would this level of debt have on our economy as a whole?

Answer: The following table shows what federal debt and interest costs would be if the unified budget deficit were held constant in 1985 and thereafter at $192 billion.

FEDERAL DEBT AND INTEREST COSTS ASSUMING DEFICITS OF $192 BILLION PER YEAR (By fiscal year) a/

	1984	1985	1986	1987	1988	1989
In Billions of Dollars						
Net Interest	110	125	143	162	182	196
Debt Held by the Public	1,330	1,534	1,740	1,946	2,153	2,359
As a Percent of GNP						
Net Interest	3.1	3.2	3.4	3.5	3.6	3.6
Debt Held by the Public	37.3	39.2	40.9	42.2	43.2	43.9

a/ The 1984 deficit is estimated to be $189 billion.

While holding the deficit at $192 billion per year would represent a substantial improvement compared to the levels in CBO's baseline projections, the deficits would not be small enough (as the table shows) to prevent the debt from growing as a percent of gross national product. Deficits of this size are still large enough to raise the same concerns about high interest rates and growing interest costs that are discussed in our Analysis of the President's Budgetary Proposals for Fiscal Year 1985.

BALANCED BUDGET GOAL

Question: The President suggested in his State of the Union message that increasing taxes would pose a real threat to economic recovery and that a balanced budget could be achieved by spending reductions. From your perspective at the CBO, how would you advise the President to achieve this goal within the four years of his next term?

Do you think it is possible to balance the budget without raising taxes?

Can a balanced budget be achieved without reductions in entitlement programs, chiefly Medicare and Social Security?

Can we continue to increase defense spending and hope to have a balanced budget?

Answer: As I mentioned in my prepared statement, Senator, given the composition and dynamics of the federal budget, I

believe that there is a broad consensus that balancing the budget will have to include both spending cuts and tax increases. I personally hold this view as well. There is no agreement, however, over what proportions of each are appropriate, and I have no recommendations to make on that score, in accordance with CBO's mandate.

Again, given the composition of spending, one is driven to the conclusion that spending cuts must include both defense and entitlement programs. Together with net interest costs, these categories of spending account for 90 percent of the total spending projected for the 1985-1989 period. As observed by Wille Sutton, "You have to go where the money is." This is not to say that other spending shouldn't be reduced as well. It's just that defense and entitlement spending make up such a large portion of the total pie that if the pie is to be cut, these programs will have to take some of the cuts.

U.S. TRADE DEFICIT

Question: U.S. Trade Representative Brock has warned that an unfavorable balance of trade will continue to exist for several more years. Do you think this trade deficit will hamper efforts at economic recovery?

Answer: Our balance on merchandise trade continues its steep decline. Starting from a somewhat weaker than normal trade position just prior to the onset of the last recession, the deterioration of our merchandise balance from 1981 to early 1984 was unprecedented. Furthermore, the continuing effects of the strong dollar, along with anemic rates of growth abroad suggest that large trade deficits will persist through 1984 and well into the following year.

So far, the growing trade deficit has not stunted the economic recovery under way. Neither do I expect the continuing expansion to be derailed this year by record high trade deficits. With some weakening of the dollar on international exchanges and improving growth prospects around the world, the deterioration of the U.S. trade balance may soon come to an end. Yet, the trade deficit is most likely to remain abnormally high for a few more years and may ultimately become a drag on U.S. economic growth.

Question: Mr. Brock attributes the trade deficit to an overvalued dollar. What has caused the dollar to be overvalued? Have our high interest rates contributed to its high exchange value?

Answer: Based on the IMF indexes of the real exchange rates, the exchange value of the dollar is 30 percent higher than can be attributed to differences in countries' underlying cost and inflation rates.

The driving force behind the strong dollar is the net inflow of foreign capital over the last three years. These inflows are based on several factors. Interest rate differentials

have played an important role with higher yields on dollar-denominated assets than on foreign currency assets. Capital inflows have also been stimulated by the perception of economic opportunities created by the strong U.S. recovery. Finally, the relative political and economic stability of the U.S. has attracted funds seeking a "safe-haven."

Question: Can we reduce the trade deficit without reducing interest rates?

Answer: Several factors are responsible for the U.S. trade deficit. As indicated in the response to your previous question, net inflow of capital from abroad has led to an appreciation of the dollar and has reduced the price competitiveness of U.S. exporters and import-competing industries. The Federal Reserve Board had estimated that between mid-1980 and mid-1983 the appreciation of the dollar caused a $40 billion deterioration in the U.S. trade balances (at an annual rate). In addition, the earlier and more rapid pace of the U.S. recovery relative to that of our trading partners has brought a surge in U.S. imports without a corresponding increase in foreign demand for U.S. exports. The international debt crisis has also led to a fall in LDC demand for U. S. products.

The rate of economic growth of our industrialized trading partners is expected to increase over the next two years and this should stimulate U.S. exports and thus reduce the trade deficit. The outlook for the LDCs is not as sanguine. The austerity measures that they have undertaken imply that their demand for our products may be depressed over a long period.

It is certainly not impossible that our trade deficit may shrink even if the interest rates stay at present levels. A drop in interest rates, however, and the depreciation of the dollar that can be reasonably expected to accompany it would undoubtedly be welcomed by our export and import-competing industries.

Question: Is there any correlation between large deficits and a strong dollar?

Answer: One must be careful to recognize the role of the business cycle in affecting deficits and interest rates. Often, large budget deficits are associated with recessions, and interest rates typically fall in a recession as the private demand for credit slackens. Thus, the historical record gives a mixed view of the relation between budget deficits, interest rates, and the value of the dollar.

Currently, however, the United States is running massive budget deficits during an economic expansion. The budget deficits have put upward pressure on U.S. interest rates making U.S. assets attractive to foreign investors. According to preliminary estimates, net capital inflows into the United States were approximately $35 billon in 1983. These inflows have sustained the dollar at its high level and, thus far, have been of sufficient size to offset the downward pressure exerted on the dollar by the large U.S. current account deficits.

TIMING OF DEFICIT-REDUCTION MEASURES

Question: It has been suggested that this is an "election-year budget." Do you think we can afford to wait until after the election to take steps to remedy the current situation?

Answer: The delay of significant action to curb deficits until after the 1984 election would expose the economy to high risks, impede taking efficient actions, and would reduce budget flexibility for future years.

Real interest rates are very high now, at least in part because of high prospective deficits. These high interest rates have contributed to a strong dollar but to weak export and import-competing industry performance. They threaten to slow down the growth of the capital stock of the United States, a major contributor to high standards of living. The key ingredient to altering the market's psychology and breaking the high real interest rates is decisive action to reduce prospective deficits. To wait until after the election is to risk--between now and the time action is taken--further unbalanced economic growth, a loss of confidence leading to sharp withdrawals of foreign capital, and conceivably an end to economic recovery.

A credible budget reduction plan may not need to incorporate great dollar savings in fiscal year 1985, but unless action is taken in the 1985 budget to reduce deficits for the years beyond it will become harder to make sensible changes in those outyears. Because of low spendout rates, to reduce spending for military hardware in the outyears requires action now. To curb entitlement COLAs in the future while minimizing hardship requires advance action so that recipients can adjust. And curbing the deficits through actions that raise revenues in the future is best done sooner rather than abruptly--both to give time for administrative adjustments and to allow businesses and consumers to plan.

Each year we delay acting on the budget deficit means another permanent increment to the national debt, on which the government has to pay interest. Under our baseline projections for 1989 net interest outlays represent 45 cents of every dollar in individual income taxes projected for that year. This is more than double the burden of paying interest for the past three decades. To halt the rise in the ratio of public debt to GNP, which is driving interest up, every year counts and every year of postponement of action hurts.

Finally, delaying action until after the election presupposes that the political climate for action will be better in 1985. While CBO cannot comment on that climate, two issues warrant attention. First, 1985 will be the third year of the current recovery. Historically, the third year of a recovery is a period of mixed economic trends, not strong growth as is currently the case. Second, 1985 begins a new session of Congress and possibly a change of administration. Historically, such circumstances are not conducive to quick action. Should such be the case in 1985, deficit-reduction action may be delayed until well into the year.

CONCLUSION OF HEARINGS

Senator ABDNOR. We will recess until the call of the Chair. Thank you.

[Whereupon, at 11:59 a.m., Wednesday, February 22, the hearings were concluded, and the committee was recessed, to reconvene at the call of the Chair.]

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